Fiscal Research Program

THE GEORGIA INCOME TAX : SUGGESTIONS AND ANALYSIS FOR REFORM

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FRP Report No. 2
November 1997

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As the Georgia economy has grown and changed over the past two decades, so has the state's reliance on the individual income tax. While the tax has served the state well, the Georgia economy and population have changed and there are now opportunities to modernize the income tax to bring it more into synch with the economy. This is the motivation for this research, to point the way toward future adjustments in the income tax, and to lay out the policy options that are open in the future. There is no crisis in income taxation in Georgia, and so it is the best of times to discuss how this tax might be adjusted in the future.

1. Georgia is one of 43 states which impose an individual income tax and is one of 14 states which authorize the use of a local income tax. Georgia was one of the earliest states to use an income tax, but no local governments in Georgia have ever adopted a local income tax.

2. Since the initial imposition of the individual income tax in 1929, the state's reliance on the tax has grown. In 1970, the income tax comprised 20.4 percent of state government net revenue. By 1996, that share had risen to 42.6 percent.

3. Some significant advantages offered by the individual income tax are that it is income elastic (e.g., its revenues grow faster than the growth in income); it is progressive in its distribution of tax burdens; it is relatively neutral in its effects on economic decisions, thus reducing distortions within the economy; and it is deductible at the federal level, reducing the overall burden on a third of Georgia residents. Opponents of the tax contend that, because it is income elastic, revenues may decline during economic downturns; the progressivity of the tax may discourage higher-income individuals from living in Georgia and locating their businesses in the state; "bracket creep" due to inflation results in potentially increased tax burdens with no change in real income; the tax is often used to give special preferences to certain groups or certain income types, thus disrupting the equity and efficiency advantages of the tax; taxpayers feel that compliance with the tax is cumbersome and expensive; and the tax requires a high level of administration, which is costly.

4. The same basic structure of the individual income tax has existed since 1937, with the last major set of adjustments occurring in 1987. The tax calculation begins with federal adjusted gross income. After making adjustments for retirement income and social security benefits, lump sum distributions, and interest earned on Georgia and federal obligations and deductions for exemptions and either federal itemized deductions or the standard deduction, a graduated rate structure is applied, with rates ranging from 1percent on the lowest income groups to 6 percent for income in excess of $10,000 for married filing jointly and head of household filers. Tax credits for low income filers, tax payments to other states, and economic development activities are then deducted to arrive at the tax payable.

5. When comparing the structure of Georgia's individual income tax with those in the Southeast and throughout the nation, several observations are appropriate. The tax structure is relatively "clean", with few adjustments and credits. The number of brackets is similar to that of other states, but the rates are a bit lower than those of the nation as a whole. The tax brackets are relatively narrow, with the top taxable income bracket being imposed at a lower income amount than that of most other states. The income tax structure does not provide for indexation of rates or brackets. The elderly with retirement income receive more generous tax treatment than that provided by most states for non-state pensioned retirees.

6. Comparison of the revenue received from the individual income tax in Georgia to other states in the Southeast region shows that Georgia receives a much higher percentage of total state tax revenue from this tax than the other states, with the exception of Virginia. Two factors explain the high percentage of revenues obtained from the individual income taxes. First, Georgia reaches the threshold of its highest taxable income at lower income levels than most states in the region. Second, Georgia's per capita income is higher than the average for the Southeastern states, providing a larger taxable base relative to population than most of the other states.

7. How is the state income tax burden (taxes paid as a percent of income) distributed in the state? Using 1993 income levels and applying the requirements of laws in effect for 1996, we conclude that the tax burden is progressive throughout the entire range of income. Households earning less than $5,000 have a tax burden of .01 percent, while households with incomes in excess of $100,000 have the highest burden, 4.61 percent. Households in the middle-income brackets have an average tax burden of 3 to 4 percent.

8. A thorough analysis of Georgia's individual income tax uncovers the following policy issues which could be addressed through changes in the individual income tax code:

   a. The individual income tax is becoming a flat rate tax due to the low income level at which the tax rate is reached and the lack of indexation.

   b. While the system is not overly complex, the complexity could be reduced by using either federal taxable income or the federal tax liability as the tax base.

   c. The cost of the retirement income deduction is high. Georgia offers one of the most generous retirement income deductions. As the numbers of retirees grow, income exempted from individual income taxation will continue to grow, which will erode the individual income tax base. Considerations for change include lowering the retirement income deduction and using the federal guidelines for determining the taxable portion of social security benefits while increasing the standard deduction and personal exemption for all individuals. These measures would afford protection to the poor elderly as well as the poor population in general.

d. The growth and importance of the individual income tax presents a cause for concern. The state relies heavily on the income tax, but the elasticity of the tax has decreased somewhat over the last decade. Much of the natural growth has been "used up" since the majority of individuals are in the highest tax bracket and the state has afforded retirement income increased exemptions. Policy makers should address two specific questions--is a stable source that grows predictably with income desired or is it time to increase elasticity to ensure continued long-term growth of the individual income tax. If a stable source is desirable, a flat-rate tax would be preferable to the current structure. If increased elasticity is desired, additional brackets could be added or existing brackets widened.

e. Currently, none of Georgia's individual income tax system is indexed for inflation. This lack of indexation results each year in additional low-income individuals having to pay an income tax, even though their inflation-adjusted income may not have increased. The state has made some adjustments through increases in exemptions and deductions, but these adjustments are not done regularly. An annual system of indexing would decrease political and time cost of adopting reforms every few years. It also serves to protect individuals with relatively low incomes from being subject to income taxation.

f. Although not as significant as the first five issues, two other issues should be addressed. First, the state allows itemizing individuals to deduct state income tax paid to Georgia within the calendar year, effectively lowering the tax rate for individuals that itemize, reducing potential state revenues and decreasing horizontal equity. Second, the state individual income tax system exempts the unearned income of dependents, leading to revenue losses for the state and reducing the horizontal and vertical equity of the system.

9. This report considers six policy options to address the issues listed above.

a. Increase the standard deduction of all filers to the 1996 federal standard deduction level. *Anticipated effects:* Decrease individual income tax receipts by 5.0 percent and lower the tax burdens for all filers.

b. Increase the personal exemption for all filers to the 1996 federal levels. *Anticipated effects:* Decrease individual income tax receipts by 4.5 percent and decrease the tax burden for all filers.

c. Increase both the personal exemption and standard deductions to the 1996 federal levels. *Anticipated effects:* Decrease individual income tax receipts by 9.3 percent and lower the tax burdens for all filers.

d. Use Georgia's adjusted gross income as currently defined by Georgia's Tax Code with federal exemptions and deductions, and a 6 percent flat rate for all taxpayers. *Anticipated effects:* Increase individual income tax receipts by 8.2 percent and decrease the progressivity somewhat, with all except the lowest income groups experiencing slightly higher effective income tax rates. This option decreases the current elasticity of the income tax, but would simplify the system.

e. Eliminate all retirement income exemptions. *Anticipated effects:* Increase individual income tax receipts by 1.5 percent and would increase the tax burdens for most income groups except the very lowest. Over time, this change would increase the elasticity of the tax, relative to the present system.

f. Add a 7 percent tax bracket at $8,250 for singles, $13,000 for married filing jointly, and $6,550 for head of household filers. *Anticipated effect:* Increase individual income tax receipts by 12.6 percent, increase the progressivity and elasticity of the system, and increase the tax burden for all but the lowest income groups.

I. INTRODUCTION

Across the country, the personal income tax is an important revenue source for state governments. In 1995, the individual income tax accounted for 31.5 percent of all state tax collections, making the individual income tax second only to general sales, use, and gross receipts taxes as a state revenue source. The individual income tax constituted an average of 24.0 percent of all state own-source revenue in 1995.[1]

While 43 states and the District of Columbia impose some form of an income tax, the state of Georgia was one of the individual income tax pioneers.[2] When Georgia introduced the tax in 1929, only 14 other states imposed the tax. Since the early days of the personal income tax, the state's reliance on the tax has grown. In 1970, the income tax comprised 20.4 percent of state government net revenue. By 1996, that percentage had risen to 42.6 percent.[3]

Given the heavy reliance of many states on the individual income tax, it might appear frivolous to ask the question, "Why have an income tax?" but the question provides a good framework for analyzing the need for reform in Georgia. Proponents would list the following reasons for having an individual income tax:

1. It is income elastic, i.e., its revenues grow in proportion to income.[4]
2. It is progressive in its distribution of tax burdens.[5]

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[1] U. S. Bureau of the Census, Internet site, http://www.census.gov/ftp/pub/govs/www/index.html (accessed 02/17/97).

[2] Of the 43 states, Tennessee and New Hampshire impose a very limited tax on interest and dividends. States with no personal income taxes are Alaska, Florida, Nevada, South Dakota, Texas, Washington, and Wyoming.

[3] Georgia State Department of Revenue, *Statistical Report,* various years.

[4] Elasticity refers to the percentage change in tax revenue divided by a percentage change in income.

[5] A progressive tax is one where the tax paid is a higher percentage of income as income increases.

3. It can be relatively neutral in its effects on economic decisions, thus reducing distortions in the economy.

4. It is deductible at the federal level, thus reducing the overall burden on Georgia residents.

Those who are less taken with these virtues of the individual income tax also make strong arguments against the income tax:

1. Because it is income elastic, revenues may decline during economic downturns.

2. The tax is progressive which may discourage higher-income individuals from living in Georgia and from locating their businesses in the state.

3. "Bracket creep" due to inflation results in potentially increased tax burdens with no change in real income; a progressive rate schedule may guarantee that taxes will grow faster than real income.

4. The tax is often used to give special preferences to certain groups or certain income types, thus disrupting the equity and efficiency advantages of the tax.

5. Taxpayers feel that compliance with the tax is cumbersome and expensive.

6. The tax requires a high level of administration which is costly.

In this report, we provide an analysis of the ingredients of income taxes and of the individual income tax in Georgia. We summarize the income tax history and use in the state, and analyze the tax with respect to deductibility, progressivity, equity, and efficiency. Finally, we compare the structure, use, and yield of the individual income tax in Georgia relative to that in other states. Based on this work, we have developed a list of concerns regarding the individual income tax in Georgia. This list includes:

- the elasticity of the tax;
- the effective flat rate tax structure;

- the low level of personal exemptions;
- indexation of rates and/or brackets;
- simplicity of the system; and
- the income exemptions for the elderly.

This list of concerns leads to a number of options for reform ranging from a relatively simple change in personal exemption amounts to a more complex overhaul of rates, base, and brackets. A number of these options were considered and in the last section of this report, we present analyses of alternative policy changes, using the Georgia State Individual Income Tax Simulation Model (GSITSM).

II. ISSUES IN THE DESIGN OF THE INDIVIDUAL INCOME TAX

To evaluate the issues surrounding the individual income tax, it may be useful to start with an actual tax structure, that of Georgia. The Georgia individual income tax is imposed on the taxable net income of all residents and non-residents of Georgia. Taxpayers can file returns based on one of the following categories: single, married filing separately, head of household, or married filing jointly. Table 1 shows how the tax is computed starting from the Federal Adjusted Gross Income (FAGI).

Two sets of adjustments are made to FAGI to arrive at Georgia Adjusted Gross Income (GAGI). First, the following items are subtracted from FAGI: (1) retirement income for taxpayers aged 62 and older or for totally disabled persons up to but not to exceed $12,000 ($24,000 if married and filing jointly when both individuals earn sufficient income to qualify separately for the $12,000 exclusion); (2) social security benefits and tier 1 railroad retirement benefits to the extent included in FAGI; (3) interest or dividends on federal obligations to the extent included in FAGI if these amounts are exempt from state taxation by federal law; (4) the amount received during the year that represented contributions to the Teachers' Retirement System of Georgia by the taxpayer between July 1, 1987 and December 31, 1989 and previously taxed by Georgia; (5) salaries and wages eliminated in computing FAGI because of the federal jobs tax credit; (6) mortgage interest eliminated from FAGI due to federal mortgage interest credit claimed; (7) the amount of a dependent's unearned income included in FAGI of parent's return; (8) 10 percent of qualified payments to minority subcontractors (limited to $100,000 per tax year); (9) income from public pension or retirement funds, programs, or systems if exempt by federal law and included in the taxpayer's FAGI; (10) depreciation due to differences in Georgia and federal income tax during the tax years 1981 through 1986; and (11) withdrawals from IRA's, Keough, SEP and SUB-S plans where tax was previously paid to Georgia due to differences in state and federal law in the years 1981 through 1986.

TABLE 1
COMPUTATION OF GEORGIA TAX LIABILITY, 1996

FEDERAL AGI

subtract	*add*
- retirement income (not to exceed limits specified by Georgia law) - social security benefits (taxable portion) - railroad retirement (taxable portion) - interest on U.S. obligations - other	- interest on non-Georgia municipal & state bonds - lump sum distributions - other

=GEORGIA AGI

subtract
Georgia standard deduction *OR* Federal itemized deduction
and
Georgia personal exemptions

Singles		Married Filing Separately		Joint, Head of Household	
Rate	Taxable Income	Rate	Taxable Income	Rate	Taxable Income
1%	< $750	1%	< $500	1%	< $1,000
2%	750-2250	2%	500-1500	2%	1,000-3,000
3%	2250-3750	3%	1500-2500	3%	3,000-5,000
4%	3750-5250	4%	2500-3500	4%	5,000-7,000
5%	5250-7000	5%	3500-5000	5%	7,000-10,000
6%	>7000	6%	>5000	6%	> 10,000

=TAX BEFORE CREDITS

subtract

credits (low-income tax, employment/investment tax,
credits for tax payments to other states, and other credits)

=GEORGIA TAX LIABILITY

In the second set of adjustments, the following items are added to FAGI: (1) dividend or interest income on obligations of any state or political subdivision except Georgia and its political subdivisions, to the extent excluded from FAGI; (2) interest or dividends on federal obligations if exempt from federal income tax but not state income tax; (3) lump-sum distributions from an annuity, pension plan, or similar source that were removed from FAGI because of special federal tax treatment; (4) loss carry-overs from years when the taxpayer was not subject to Georgia income tax; (5) depreciation due to differences between Georgia and federal tax laws in tax years 1981 through 1986; (6) any income taxes imposed by any taxing jurisdiction, except Georgia, to the extent deductible in determining federal taxable income; and (7) proceeds from lottery prizes.

Georgia taxable income is then derived by subtracting the following amounts from GAGI: (1) either itemized nonbusiness deductions used in computing the federal taxable income or a standard deduction, with additional $700 deductions allowed when the taxpayer and/or spouse (for joint returns) is blind or aged 65 or older and (2) Georgia's personal exemptions of $3,000 for joint filers and $1,500 for individuals using other filing types, with $2,500 allowed for each dependent. The standard deduction allowance also varies by filing status, with a deduction of $2,300 for single and head of household; $1,500 for married filing separately; and $3,000 for married filing jointly.

A graduated rate structure ranging from 1 to 6 percent is applied to the Georgia taxable income to arrive at the before-credit tax liability. Six main credits are allowed: (1) a credit for income taxes paid upon business, investments, or income from employment in another state by residents provided that the credit does not exceed the tax which would be payable to Georgia on a like amount of taxable income; (2) for taxpayers who did not receive a food stamp allotment during the year, a low income credit for residents, based on the taxpayers' income and number of dependents, with taxpayers 65 and older being eligible to claim double credit; (3) for self employed and other employers, credits for business expansion within certain areas of the state, for sponsoring approved retraining programs, and for providing child care for employees; (4) credits for qualified water conservation investments and purchases from qualified water conservation facilities; (5)

credits for physicians who establish a practice in a rural county after July 1, 1995 for up to five years and up to $5,000; and (6) credits for the creation of jobs by qualified business enterprises.[6] Subtracting these credits from the pre-credit tax liability results in the taxpayer's net tax liability.

The remainder of this section discusses issues regarding the use of an individual income tax. These issues pertain to any government's use of the tax.

Vertical Equity and Progressivity

When evaluating the virtues of a tax, economists commonly ask two questions. First, can we identify and tax the individual who will receive the ultimate benefit (in the form of government goods and services) of the tax? Second, is the amount of the tax levied on an individual "fair?" The approach to taxation which addresses the first question is derived from the benefit principle. This approach is suitable in the case of user fees where there is a *quid pro quo* of government goods and services received for taxes (fees) paid.

For other types of goods and services provided by governments (i.e., defense, national forests, etc.), it is unclear how to measure the benefit received by any particular individual. General taxes, such as the individual income tax, are more appropriate than are specific taxes for financing these types of goods and services. In these instances, the overriding consideration in determining which individuals to tax and how much is the principle of tax fairness based on ability to pay. This principle requires that those with equal abilities (however defined) pay the same amount of taxes and

[6] The legislation concerning tax credits for business expansion categorizes counties according to their degree of development into three different "tiers". The regulations provide different credit amounts for development in each tier and are based on creation of new jobs and investments in property within the counties. Minimum numbers of jobs created and minimum investment amounts exist for the different tiers. Similar provisions are afforded for inner cities.

that those with greater abilities pay more taxes. This latter component of the ability-to-pay principle is referred to as vertical equity. When applying this principle, taxes may be described as either regressive, proportional, or progressive, based on the percentage of income extracted by the tax, as income increases. A regressive tax decreases as a percentage of income, as income rises. The example in Box 1 demonstrates a regressive tax and serves to clarify this concept. An income tax structure that is regressive over some income ranges is uncommon. However, Citizens for Tax Justice (1996) found that Alabama's state income taxes had some degree of regressivity, due to two factors: (1) the tax brackets contained low thresholds, with taxpayers entering the highest tax bracket when taxable income exceeded $6,000 and (2) the state allowed the taxpayer to deduct federal income tax before calculating the state income tax liability. Both of these factors caused the estimated burden for the taxpayers in the top income quintile (upper 20 percent of incomes in the state--with taxable incomes of $64,000 or more) to have an average tax burden *lower* than that of the two quintiles immediately below it (incomes of $33,000 to $64,000). Thus, the middle-income taxpayers in the state paid a higher percentage of their income as personal income tax than the higher-income groups.[7]

A proportional tax remains a constant percentage of income, regardless of the income level. Eleven states levy a constant percentage tax on various income measures. Box 2 lists the different states which have one-rate individual income taxes, showing the basis for the tax, as well as whether exemptions and deductions are allowed. The deductions, exemptions, and credits in these state

[7] Pennsylvania is the only other state with a broad-based income tax that showed some degree of regressivity in its income tax. This regressivity was noted between the two upper income quintiles in the state (Citizens for Tax Justice, 1996).

income tax systems generally resulted in the income tax being progressive. Citizens for Tax Justice (1996) found that only one state, Illinois, had a personal income tax structure that yielded a proportional tax over some range of incomes. According to their analysis of 1995 state and local taxes, the average taxpayers with incomes in the upper three quintiles or sixty percent of Illinois' taxpayers paid the same share of their income in personal income tax--2.5 percent.[8]

Box 1
Example of Tax Regressivity

The social security tax is levied as a fixed percentage (6.2 percent in 1997) on amounts up to $65,400 received by the individual in the form of wages, salaries, and income from self employment. Earnings in excess of the $65,400 limit are not subject to the tax. When individuals begin collecting social security, their payments are based on their "contributions" to the social security system. Before payments begin, however, the social security tax can be viewed as a regressive tax when comparing individuals with incomes above $65,400 to other individuals. The accompanying example assumes that all income for these three individuals arises from sources subject to the social security tax. As incomes increase above the $65,400 threshold, the tax becomes increasingly regressive. Note that individuals who have incomes above the threshold throughout their lifetimes will experience greater regressivity relative to their cohorts earning less than them, but who also earn above the threshold.

	Individual 1	Individual 2	Individual 3
Income	$ 50,000	$ 100,000	$ 200,000
Total annual social security tax	3,100	4,054.80	4,054.80
Tax burden (Income / Total annual tax paid)	6.2%	4.1%	2.0%

[8] In general, taxpayers with incomes above $46,000 paid the same percentage of their income in personal income taxes. Below that amount, some progressivity existed in the personal income tax structure, in part due to the deductions and credits offered by the state.

Box 2
Flat-Rate Income Taxes--Various States--1996

As the table shows, the basis varies from modified FAGI to more restrictive measures, such as interest and dividends. The provisions for exemptions and deductions allowed by some states complicates the calculations and prevents the tax from being truly proportional.

			Exemptions		Deductions	
State	Rate	Basis[1]	Yes	No	Yes	No
Colorado	5.0	Federal taxable income		x		x
Illinois	3.0	Taxable net income	x			x
Indiana	3.4	Modified AGI	x			x
Massachusetts	12.0	Interest/dividends/ net capital gains		x		x
	5.0	5 classes of capital gains income		x		x
	5.95	All other income	x			x
Michigan	4.6	Taxable income	x			x
New Hampshire	5.0	Interest/dividends only	x			x
North Dakota[2]	14.0	Federal income tax liability		x		x
Pennsylvania	2.8	Specified classes of taxable income		x		x
Rhode Island	27.5	Federal income tax liability		x		x
Tennessee	6.0	Certain interest/dividends only	x			x
Vermont	25.0	Federal income tax liability		x		x

[1] AGI Adjusted gross income.

[2] North Dakota taxpayers can optionally use a graduated rate structure having 8 brackets, with rates ranging from 2.67% to 12%.

Source: Commerce Clearing House (CCH), Inc., *State Tax Guide*, 1997.

A progressive tax provides greater equalization of after-tax incomes by reducing the after-tax income of high-income taxpayers more than that of low-income taxpayers. If we accept that redistribution of income is a valid role for governments, then a progressive tax is preferable.

Musgrave (1959) argues that the redistributive role of government belongs at the federal level since any attempt by state and local governments to perform this function will be largely negated by the subsequent relocation of higher-income individuals to jurisdictions with less progressive taxes. This results in higher tax burdens for lower-income residents who are left behind if the jurisdictions are to uphold current levels of public expenditure. However, other public finance economists, notably Slemrod (1986), argue that there are some valid reasons for states to use progressive income taxes. He notes that there might be greater aversion to income inequality in one state relative to others, resulting in a desire for a more progressive income tax for that state relative to others without any distortion in location decisions. Furthermore, as Oakland (1983) points out, regional cost-of-living differences mean that a dollar of transfer from the federal government is not the same for all states. Redistributive policies by states are therefore required to achieve the intended equalization of income.

To the extent that the arguments above are true, one would expect that the degree of progressivity in the income tax will vary from state to state according to states' preferences for redistribution. What limits the degree of progressivity for state income taxes, Break (1980) notes, is the extent to which a state's redistributive policies through income taxation departs from the national "average". Such "natural" differences in the degree of progressivity between states, arising from differences in preferences (for redistribution), make it very difficult to compute any such "average" and one must be cautious in comparing the progressivity of the income tax of one state with another.

Income taxes generally are the key revenue source which introduces progressivity into a state's tax structure. When Citizens for Tax Justice (1996) judged three of Georgia's neighbors to have some of the most regressive tax systems in the U.S., the source of their high level of regressivity was the design of the states' individual income tax or the lack of an individual income tax in the state.[9] Specifically, the reasons identified for the high degree of regressivity in Alabama, Florida, and Tennessee were threefold: (1) all three states relied heavily on sales and excise taxes, which are generally quite regressive; (2) Florida lacked a state income tax and Tennessee's income tax generated a very small fraction of the state's total revenues; and (3) Alabama had both a low threshold on its highest tax bracket and the state allowed unlimited deductibility of federal income taxes, which could cause a taxpayer who paid high federal income taxes to pay very little or possibly nothing in state income taxes.

In the United States, the personal income tax is commonly used to introduce progressivity into the tax structure. All states which levy an income tax have some degree of progressivity in their structures (Citizens for Tax Justice, 1996). The elements of the tax code that are commonly used by states to effect a desired degree of progressivity include: (1) personal exemptions, (2) standard deductions, (3) graduated statutory rate structures, (4) various bracket widths, (5) credits, (6) phase-outs of deductions, (7) federal tax deductibility,[10] and (8) coupling to federal income tax liability.

Personal exemptions are commonly used in state income tax systems. In most instances, the exemption amount varies based on filing status and all states except Connecticut provide additional exemptions for dependents. In 1996, Connecticut offered the highest exemption amounts ($12,000 for individuals filing single, $19,000 for heads of household and $24,000 for individuals filing joint

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[9] Florida was ranked as the second most regressive system in the U.S., while Tennessee was ranked as fifth and Alabama as ninth.

[10] Federal tax deductibility reduces the progressivity in a tax structure because the taxpayers with higher incomes generally receive greater benefits from the deductibility.

returns). Other states were not as generous with their exemptions, with combined exemptions and standard deductions for single filers ranging from approximately $2,000 to the amount allowed for federal tax purposes.[11] The high limits and additional exemptions offered for each dependent effectively relieve many lower-income households from paying income taxes. Most states allow additional exemptions for individuals who are blind, disabled, or over 65 years old which are intended to provide additional tax relief to individuals who have limited income or opportunities for income.

The provisions for standard deductions at the state level is not as widespread as provisions for exemptions, with twelve states not providing for separate standard deductions.[12] Most of the states which offer separate standard deductions allow taxpayers to itemize their deductions. However, the rules for the use of standard and itemized deductions vary widely among the states. For example, some states require the taxpayer to use the same option (itemized versus standard deduction), as was chosen for the federal income tax returns, while other states allowed the taxpayer the option of using itemized deductions, regardless of the option chosen at the federal level. A few states which offered a standard deduction, such as Wisconsin, phased out the standard deduction for higher-income taxpayers, while a few other states, such as California, phased out itemized deductions for higher-income taxpayers.

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[11] In 1996, Connecticut did not allow a standard deduction, so this exemption amount takes the place of both a standard deduction and a personal exemption. Some states allow personal exemption credits in lieu of personal exemption amounts which can result in a higher amount of income being exempt from taxation.

[12] In 1996, the states not offering a separate standard deduction were Connecticut, Illinois, Indiana, Louisiana, Massachusetts, Michigan, New Hampshire, New Jersey, Ohio, Pennsylvania, Tennessee, and West Virginia. Louisiana provides a combined standard deduction/personal exemption allowance. Pennsylvania's structure contained provisions to exempt low-income individuals from taxation.

Under a graduated statutory rate structure, income is grouped in tax brackets, and each higher income bracket faces a higher marginal tax rate. For example, under a graduated structure the first $10,000 may be taxed at 2 percent, the next $10,000 at 3 percent, and so on. The higher and more numerous the marginal tax rates, the more progressive the tax structure. Most states utilize more than one tax bracket, with increasing marginal tax rates. For 1996, the average number of brackets for the 43 states and the District of Columbia was slightly more than four, with three-rate and single-rate systems being the most prevalent. Eight states had three-rate systems; eleven states chose the simplicity of a single-rate system.[13] Three states, Ohio, Oklahoma, and Idaho used nine brackets; with ten brackets, Missouri and Montana used the largest number of brackets. The lowest marginal tax rate used by any state was .4 percent, with rates of between 1 and 3 percent being the predominant lowest rates. The highest rate levied by any state was 12 percent, with top rates of 10 percent or less being more commonly used.[14] The width of the brackets and the marginal rates applied within brackets also varied among states. For example, in Missouri, the lowest tax, 1.5 percent, was levied on the first $1,000 of taxable income; the highest tax rate, 6 percent was levied on incomes above $9,000. In comparison, Montana's lowest tax rate was 2 percent, levied on the first $1,899 of income; the uppermost bracket, with a marginal tax rate of 11 percent began at $66,399. A look at North Carolina's income tax provides a greater contrast of rate and bracket structures. That state had three brackets, with the lowest rate of 6 percent levied on taxable income up to $21,250; a rate of 7 percent levied on taxable income from $21,250 to $100,000; and a rate of

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[13] Box 2 lists the states having single-rate systems, their rates, and other information regarding the tax basis and deductions/exemptions.

[14] Three states base their tax on the federal tax liability, with the state tax amount varying from 14 to 27.5 percent of the taxpayer's federal tax liability, as adjusted for states' differences.

7.75 percent levied on taxable income above $100,000. Looking solely at the number of brackets and rates used by a state's tax system only tells a portion of the story regarding the individual income tax progressivity in the state. These elements of the tax systems must be combined with other features of the tax system, such as exemptions, deductions, credits, and the income distribution on the population to allow conclusions to be drawn regarding progressivity.

The data in Table 2 show the average tax faced by two individuals, one with an income of $10,000 and no itemized deductions (one takes the $2,000 standard deduction) and one with $20,000 and substantial deductions. In the absence of the deductions, the average tax rate for the first individual is 3.45 percent and, for the second, it is 4.73 percent. However, when the deductions are taken, the average tax rate falls to 2.45 and 1.73 percent for the first and second taxpayer, respectively. In this example, the use of itemized deductions by the second taxpayer eliminated the progressivity of the graduated rate structure.

TABLE 2
EFFECT OF DEDUCTIONS ON TAX PROGRESSIVITY

Tax Structure:			
Taxable Income	Tax Rate	Tax	
$0 - 3,000	2%	.02 * taxable income	
3,001 - 5,000	3%	$60 + .03*(taxable income - $3,000)	
5,001 - 7,500	4%	120 + .04*(taxable income - $5,000)	
7,501 - 10,000	5%	220 + .05*(taxable income - $7,500)	
>10,000	6%	345 + .06*(taxable income - 10,000)	
		Individual 1	Individual 2
Taxable Income Before Deductions		$10,000	$20,000
Tax Without Deductions		345	945
Average Tax Rate Without Deductions		3.45%	4.73%
Standard/Itemized Deductions		2,000	10,000
Tax With Deductions		245	345
Average Tax Rate With Deductions		2.45%	1.73%

In 1996, nine states also allowed the deductibility of federal income taxes.[15] This deductibility "flattens" the progressivity of a state income tax and can, as discussed earlier, result in a regressive income tax structure over some ranges of income. As federal tax rates get higher, larger amounts are deducted for state income tax purposes, pushing higher-income individuals into lower state income tax brackets. The example in Table 3 helps to clarify this point. Using Alabama's tax code, this example shows that, when this taxpayer is allowed to deduct her federal income tax liability from state income taxes, her state tax liability falls from $3,535 to $2,866.85 and her tax burden falls commensurately.

TABLE 3
EFFECT OF FEDERAL TAX DEDUCTIBILITY
FOR THE TAX YEAR 1996

	With federal deductibility	Without federal deductibility
Income	$75,000	$75,000
Personal Exemption (federal)	2,550	2,550
Standard Deduction (federal)	4,000	4,000
Federal Income Tax	16,363	16,363
Personal Exemption (state)*	1,500	1,500
Standard Deduction (state)	2,000	2,000
State Taxable Income	55,137	71,500
State Income Tax	2,866.85	3,535
Tax Burden	3.82%	4.71%

Source: CCH, Inc., *State Tax Guide*, 1997; CCH, Inc., *1997 U.S. Master Tax Guide*, 1996.

[15] Utah allowed a deduction of 50 percent of federal income tax liability. Missouri limits the deductibility to $5,000. Oregon also limits the amount of federal tax deductible. The other six states, Alabama, Iowa, Louisiana, Montana, North Dakota and Oklahoma allowed full deductibility.

Finally, the use of *deductions* versus *credits* may also influence the progressivity of a tax structure. Deductions are subtractions from income and are therefore made before the tax calculation. Credits on the other hand are subtractions from the tax liability itself. A $10 credit reduces everyone's tax liability by $10 (and therefore government revenue by the same amount), whether taxpayers are in a high or low tax bracket. A $1,000 deduction costs the government $1,000 times the marginal tax rate and reduces the tax liability more for an individual with a higher marginal tax rate. This case is made in Table 4.

TABLE 4
EFFECT OF DEDUCTIONS VERSUS CREDIT
FOR TAX YEAR 1996

Taxable Income before additional deduction or credit	$10,000	$50,000
Deduction	1,000	1,000
Credit	200	200
Tax liability no deduction or credit	1,504	10,887
Tax liability with deduction	1,354	10,607
Tax liability with credit	1,304	10,687
Dollar value of deduction	150	280
Dollar value of credit	200	200

Assumes: Federal tax schedule for single filers.
Source: Calculations of the authors based on CCH, Inc., *1996 U. S. Master Tax Guide*, 1996; CCH, Inc., *State Tax Guide*, 1997.

While vertical equity is commonly used to justify a progressive state income tax structure, states are questioning the impact of high income taxes on labor and firm migration. Higher-income individuals may feel that they are forced to bear "too high" a tax burden and choose to relocate or curtail productive activities. Empirical evidence shows that taxes influence such migration, but, after considering other public taxes and services, the effect is relatively minimal (Bartik, 1991; Wasylenko, 1991). Georgia's highest marginal tax rate is currently far enough below the top rates of most states to cause much concern about migration issues. However, the tax structure in Georgia's neighboring states may cause some migration motivated by differences in tax burdens to occur. Table 5 shows estimates of personal income and total tax burdens for Georgia and its neighboring states for 1995, as compiled by Citizens for Tax Justice. As this table shows, taxpayers in some income groups have a strong financial incentive to relocate to another state. Considering only the personal income tax burden, however, can be misleading. For example, when the overall tax burden is considered for Tennessee and Florida, taxpayers in the lowest income groups pay a higher percent of their income in taxes than their counterparts in the other states shown. Differential rate structures also impose inefficiencies in the tax system, as individuals attempt to minimize their tax burdens. For any given state, these issues must be weighed against the use of the income tax for redistributive purposes.

TABLE 5
TAX BURDEN - INDIVIDUAL INCOME TAX AND TOTAL TAXES
FOR TAX YEAR 1995[1]

State	Personal Income Tax Burden Income Grouped in Percentiles					Total Tax Burden (after federal deductibility)[2] Income Grouped in Percentiles				
	0-20%	20-40%	40-60%	60-80%	80-100%	0-20%	20-40%	40-60%	60-80%	80-100%
Alabama	1.8	2.8	3.2	3.2	2.9	11.5	10.3	9.0	7.8	5.5
Florida	0	0	0	0	0	14.0	9.8	7.6	6.4	4.3
Georgia	0.9	2.8	3.5	3.8	4.2	11.1	9.9	9.3	8.4	6.7
N. Carolina	1.0	2.9	3.9	4.4	5.2	9.6	9.7	9.1	8.7	7.0
S. Carolina	0.1	1.2	2.8	3.8	4.6	8.0	7.0	7.8	7.8	6.5
Tennessee	0	0	0	0	0.2	12.3	9.3	7.6	6.4	4.4

[1] Amounts represent shares of family income for non-elderly married couples.
[2] These percentages reflect the benefits from deductibility of state and local income and property taxes at the federal level.

Source: Citizens for Tax Justice, *Who Pays? A Distributional Analysis of the Tax Systems in All 50 States*, 1996.

Horizontal Equity

Horizontal equity refers to the "equal treatment of equals." In taxation, the principle of horizontal equity requires that "equally situated" taxpayers pay the same level of tax. The difficulty with this concept lies in the definition of equals. For individual income tax purposes, taxpayers usually have very different family situations and consumption patterns. While such differences make the classification of equals nearly impossible, tax systems control for differences in family size by using personal exemptions for each family member and provide for unplanned consumption by allowing medical and catastrophic deductions. Additional deductions and exemptions, such as home mortgage interest deductions and retirement exemptions, may disrupt the horizontal equity of a tax system and result in a less "fair" tax system. Box 3 illustrates the issue of horizontal equity using the current Georgia tax code. Looking at the extent to which states' tax codes discriminate in their treatment of different kinds of income allows a rough comparison of horizontal equity between states. The exclusions and adjustments columns of Table 6 shows that Georgia is generally in line with its neighbors regarding horizontal equity. Georgia does exclude relatively more retirement income than most of its neighbors, which creates a type of unfairness in the system. The state should consider this issue and ask why a retiree's income is largely exempt, when the average working person must pay tax on the full amount of income.

Box 3
An Example of Horizontal Equity & Income Tax

Tax structures can move toward or away from horizontal equity. Shown below are calculations for Georgia taxpayers A, B, and C, who each earn an income of $20,000 annually. Taxpayer A's income is purely salary income; B has a salary of $10,000 and earns $10,000 in retirement income; C has a $10,000 salary and earns $10,000 in interest from U. S. government bonds. To simplify the calculations, we assume that all three taxpayers are single. The result is that taxpayer A will have a tax liability of $779 which is $592 more than taxpayers B and C who will each incur a tax liability of $187. The Georgia tax code, by treating different kinds of income differently, violates the principle of horizontal equity.

	A	B	C
Federal Adjusted Gross Income	$20,000	$20,000	$20,000
Less Adjustments for (retirement income/government bond interest)	0	10,000	10,000
Georgia Adjusted Gross Income	20,000	10,000	10,000
Less:			
Standard Deductions	2,300	2,300	2,300
Georgia Exemptions	1,500	1,500	1,500
GEORGIA TAXABLE INCOME	16,200	6,200	6,200
GEORGIA TAX LIABILITY	779	187	187

TABLE 6
EXCLUSIONS AND ADJUSTMENTS TO INCOME
FOR THE TAX YEAR 1996

State	Exclusions and Adjustments to Income[1]	State	Exclusions and Adjustments to Income[1]
Alabama	*exclude:* - pension benefits (under a defined benefit plan) - retirement income from government plans - unemployment benefits - moving expenses (limited to moves to new place of work within the state) - social security benefits *include:* - lottery winnings	Arkansas	*exclude:* -$6,000 retirement or disability benefits - unemployment benefits - moving expenses (itemized deduction) - social security benefits *include:* - lottery winnings
Georgia	*exclude:* - $12,000 of retirement income for taxpayers aged 62 or older - moving expenses (itemized deduction) - social security benefits *include:* - lottery winnings - interest on bonds (non-Georgia municipal and state) - lump sum distributions - unemployment benefits	Kentucky	*exclude:* - 50%, but not more than $12,500 of retirement income from private plans - all retirement income from federal, state, and local government plans - moving expenses (limited) - limited dividend exclusion - social security benefits *include:* - unemployment benefits - lottery winnings
Louisiana	*exclude:* - $6,000 retirement income from private plans - all retirement income from government plans - moving expenses (limited) - limited dividend exclusion - $6,000 federally taxable pension income - $500 prize winnings - social security benefits *include:* - unemployment benefits - lottery winnings	Mississippi	*exclude:* - retirement income from federal, state and private sources - moving expenses (limited) - social security benefits *include:* - unemployment benefits - lottery winnings

TABLE 6
EXCLUSIONS AND ADJUSTMENTS TO INCOME
FOR THE TAX YEAR 1996

State	Exclusions and Adjustments to Income[1]	State	Exclusions and Adjustments to Income[1]
North Carolina	*exclude:* - $4,000 retirement income from government retirement plans - $2,000 retirement income from private retirement plans (total retirement income exclusion limited to $4,000) - moving expenses (federal amount) - dividends from N.C. corporations - social security benefits *include:* - unemployment benefits - lottery winnings	South Carolina	*exclude:* - $3,000 of retirement income unless deferring claim until age 65 *or* $10,000 of retirement income if age 65 and deferred claim until age 65 - other deductions as allowed under federal law *include:* - items included in FAGI
Virginia	*exclude:* - $6,000 deduction from FAGI for taxpayers aged 62-64; $12,000 deduction from FAGI for taxpayers aged 65 and older; - $600 VA lottery winnings - moving expenses (itemized deduction) - social security benefits *include:* - other lottery winnings - unemployment benefits	West Virginia	*exclude:* -$8,000 of FAGI for persons 65 or older or disabled or surviving spouse - $2,000 retirement income from military, WV state or most WV local government retirement systems *include:* - social security benefits (federal amount) - lottery winnings - unemployment benefits - moving expenses

[1]All out-of-state bond interest is taxable, and interest in U.S. obligations is exempt. In all states, IRA contributions are exempt from taxation on the same basis used by the federal government. All states exempt social security benefits from taxation, except South Carolina and West Virginia, which tax this income on the same basis as the federal government.

Note: This table is not all inclusive, but is provided to illustrate differences in the most common exclusions and adjustments to income used in the southeastern states.

Sources: ACIR, *Significant Features of Fiscal Federalism*, various years; CCH, Inc., *State Tax Guide*, 1997.

Inflation and Indexation

In most states, the individual income tax structure is not indexed for inflation. As a result, individuals may face larger increases in their real tax bill from one year to the next than in their real income. This situation is referred to as "bracket creep" and results from the structure of income taxes. Personal exemptions, standard deductions, and tax brackets are defined in dollar terms. If these statutory variables are not changed during inflationary periods, taxpayers move into higher and higher tax brackets, due to inflationary growth in their income. As taxpayers "creep" into higher tax brackets, they pay higher taxes, although their real income may not have changed. Inflation and bracket creep lead to a situation where higher percentages of *real* income are paid in tax as inflation pushes individuals into higher brackets. The original structure of an income tax is therefore compromised over time. Box 4 contains an example of the effects of inflation and bracket creep on a representative Georgia taxpayer. During the 1970's and early 1980's, the U.S. experienced historically high levels of inflation. Previously, states did not adjust their income tax brackets annually to compensate for the effects of inflation. However, this inflationary period caused the federal government and many states to enact legislation to annually index tax brackets, standard deductions, and personal exemptions. Indexing means that some or all components of the tax system are adjusted annually for inflation. For example, if the inflation rate from 1996 to 1997 is 3 percent, all of these statutory variables should be increased by 3 percent so that the average person pays the same percent of their income in tax each year. Although indexing the bracket amounts is preferable to taking no action to account for inflation, it is difficult to time the indexation appropriately since inflation calculations are made at year's end. Also, the most commonly used index, the Consumer Price Index, is calculated on a national and a regional basis, but does not consider different spending patterns among individual states. Further, the Consumer Price Index is based on a collection of goods. As the composition of that collection of goods is not updated frequently, the goods priced do not necessarily reflect the choices made by a representative consumer during the year. For example, a large percentage of the population have cellular telephones. However, this good is not included in the collection of goods priced. Such institutional issues make indexation less accurate than desirable, but the practice may nevertheless be worthwhile if the goal of a tax structure is to maintain its original effective structure.

Box 4
Example of Effects of Inflation on Tax Burden

In this example of a representative Georgia taxpayer, the standard deduction is $2,300 for single filers and the personal exemption is $1,500 per person. The rate structure contains six brackets, with rates as shown below. In 1995, the taxpayer earned $10,000 of taxable income. After exemptions and deductions were considered in calculating her income tax, her after-tax income in 1995 dollars was $9,802.50. Between 1995 and 1996, the inflation rate was 2.95 percent. Her employer granted her an inflation adjustment of 2.95 percent so that, in 1996, her total income was $10,295. Her inflation adjustment was just equal to the inflation rate, so her real income before state income taxes did not change. Since Georgia did not index its standard deduction or personal exemption allowances, her total exemptions were still $3,800. Based on her reported income of $10,295, she owes tax of $215.20 in 1996, versus $197.50 owed in 1995. For 1996, her real after-tax income in 1995 dollars was $9,790.30, versus real after-tax income in 1995 of $9,802.50. This taxpayer's loss, in 1995 real dollars, was $11.80.

Tax Structure
(not indexed for inflation)

Standard Deduction	$2,300
Personal Exemption	$1,500
1995 Earnings	$10,000
1996 Inflation rate	2.95%
1996 Earnings	$10,295

Tax Rates and Brackets

First $ 750	1.0 %
$ 751-2,250	2.0
$ 2,251-3,750	3.0
$ 3,751-5,250	4.0
$ 5,251-7,000	5.0
Over $ 7,000	6.0

Tax Calculation for 1995:

Earnings	$ 10,000.00
Total exemptions/deductions	3,800.00
Net taxable income	$ 6,200.00
Tax liability	$ 197.50
After-tax income	$ 9,802.50

Tax Calculation for 1996:

Earnings	$ 10,295.00
Total exemptions/deductions	3,800.00
Net taxable income	$ 6,620.00
Tax liability	$ 215.20
After-tax income	$ 10,079.80

Real 1996 after-tax income (stated in 1995 dollars)	$ 9,790.30
Change in real after-tax income 1995 to 1996	($ 11.80)

With the slowing in inflation rates during the past ten years, interest in indexation of income tax brackets waned. The data in Table 7 show the national inflation rates measured as changes in the consumer price index for the past sixteen years. As of 1996, seven states throughout the country used indexing within their tax systems.[16] The only Southeastern state to use indexation is South Carolina. Georgia legislators periodically propose legislation to index the individual income tax deductions and exemptions, but to date, none of these measures have passed.[17] Additionally, eleven states implicitly index their systems since their individual income tax calculations are tied to the federal system. Other states may adopt federally-indexed standard deductions or personal exemptions. However, these states must vote on the changes annually, so they are not classified as states which index their systems.[18]

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[16] Iowa indexes standard deductions and brackets; California, Maine, Oregon, and South Carolina index personal exemptions and brackets; Maine indexes standard deductions; Montana indexes personal exemptions, brackets, and standard deductions; Minnesota indexes tax brackets and adopts the federal personal exemption and standard deduction amounts (ACIR, 1995).

[17] House Bill (HB) 9, introduced in the 1997 session of the Georgia General Assembly, provided for indexation based on the Consumer Price Index for all Urban Consumers (CPI-U). However, the bill was not approved.

[18] Kentucky is an example of a state which left its personal income tax structure unchanged for a number of years. The standard deduction remained at $650 throughout the 1980's up to 1997. Kentucky's legislators, realizing the problems caused by inflation, initiated a measure to gradually increase the amount through the year 2000 to $1,700. Thereafter, the amount will be indexed for inflation annually. Similarly, Ohio left its personal exemptions' amount unchanged since the 1970's and chose to phase in an increase to compensate for inflation over a four-year period. However, the legislators chose not to automatically index these amounts in the future.

TABLE 7
INFLATION 1981 - 1996

Year	Percentage Change in Consumer Price Index
1981	10.3
1982	6.2
1983	3.2
1984	4.3
1985	3.6
1986	1.9
1987	3.6
1988	4.1
1989	4.8
1990	5.4
1991	4.2
1992	3.0
1993	3.0
1994	2.6
1995	2.8
1996	3.0

Sources: U.S. Statistical Abstract, 1985 - 1995; Department of Labor, Bureau of Economic Analysis, Internet site, 1997.

Simplicity of the System and Coupling

The complexity of a states' tax structure affects taxpayers and tax administrators alike. A basic tenet of tax theory is that a tax should place as small a compliance burden on individuals as possible (Musgrave and Musgrave, 1984). The more complex a tax structure, the higher the probability of error on the part of the taxpayer and the higher the cost for purposes of tax administration at any level of government. One way to simplify a state's individual income tax system is known as *coupling*.

Coupling refers to the use of federal income tax calculations for state individual income tax calculations. A closely-coupled state income tax starts with calculations of federal taxable income (FTI) or federal tax liability and requires few additional computations to arrive at the state income tax liability of the taxpayer.[19] In 1996, three states based their income taxes on the taxpayer's federal income tax liability -- North Dakota (14 percent), Vermont (25 percent), and Rhode Island (27.5 percent).[20] While the calculations of individual income taxes for these states is much simpler than in other states, some differences exist. In these three states' individual income tax requirements, one of the largest departures from federal requirements is in Vermont, which allows a different earned income tax credit from that allowed by the federal government. Colorado is the only state to levy its state income tax as a fixed percentage of FTI; for 1996, the tax was calculated as 5 percent of FTI.

A third way of coupling is to base the state income tax on the federal definition of adjusted gross income (AGI). In this case, the taxpayer starts the state taxable income calculation with FAGI and then makes adjustments to comply with state regulations. This level of coupling allows the states more flexibility in tailoring the individual income tax structure to meet their needs and those of their citizens. Increased costs of this flexibility arise from three sources. First, as the degree of coupling with the federal regulations decreases, the compliance cost to the taxpayer increases. Second, the state's administrative costs increase as the level of coupling decreases. Third, the differences between federal and state regulations increase the probability of taxpayers inadvertently submitting erroneous data or of them choosing not to fully comply with the state requirements due to the associated complexity. The data in Table 8 summarize the degree of states' coupling to the federal tax structure.

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[19] Differences between federal and state requirements prevent full coupling. For example, the U.S. Constitution expressly forbids states from generating tax revenue on interest earned on U.S. obligations. As these amounts are taxable at the federal level, the taxpayer must adjust their taxable amounts to exclude these earnings from taxable income.

[20] CCH, Inc., *State Tax Guide*, 1997.

TABLE 8
STATE'S COUPLING
FOR TAX YEAR 1996

State	Degree of Conformity to Federal	State	Degree of Conformity to Federal
Alabama	FTI	Montana	AGI
Alaska	No state income tax	Nebraska	AGI
Arizona	AGI	Nevada	No state income tax
Arkansas	No	New Hampshire	Only interest and dividends are taxed
California	AGI	New Jersey	No
Colorado	FTI	New Mexico	AGI
Connecticut	AGI	New York	AGI
Delaware	AGI	North Carolina	FTI
D. C.	AGI	North Dakota	Based on federal liability
Florida	No state income tax	Ohio	AGI
Georgia	AGI	Oklahoma	AGI
Hawaii	FTI	Oregon	FTI
Idaho	FTI	Pennsylvania	No
Illinois	AGI	Rhode Island	Based on federal liability
Indiana	AGI	South Carolina	FTI
Iowa	AGI	South Dakota	No state income tax
Kansas	AGI	Tennessee	Only certain interest and dividends are taxed
Kentucky	AGI	Texas	No state income tax
Louisiana	AGI	Utah	FTI
Maine	AGI	Vermont	Based on federal liability
Maryland	AGI		
Massachusetts	AGI	Virginia	AGI
Michigan	AGI	Washington	No state income tax
Minnesota	FTI	West Virginia	AGI
Mississippi	No	Wisconsin	AGI
Missouri	AGI	Wyoming	No state income tax

Source: ACIR, *Significant Features of Fiscal Federalism, Volume 1*, 1996; CCH, Inc., *State Tax Guide*, 1997.

Although some states provide for automatic adoption of federal changes in their individual income tax structure, Georgia law requires legislative approval of all changes in state tax law.[21] To

[21] Article 7, Paragraph 1 of the Georgia Constitution states in part, "The state may not suspend or irrevocably give, grant, limit, or restrain the right of taxation...the right of taxation shall always be under the complete control of the state."

comply with changes in federal laws, the state must legislatively adopt the new regulations as the basis for the state's tax system.

When Georgia does not promptly follow changes in the federal tax code, tax requirements become more complex for both the taxpayer and the state. For example, when the federal government enacted the Tax Reform Act of 1986 (TRA86), Georgia did not immediately change its regulations. Although Georgia did enact laws in subsequent years to more closely couple with the federal regulations, those requirements did not apply retroactively. Some ramifications of those years of wide disparity between federal and state regulations continue to cause excess compliance and administrative costs. One area in which this disparity between the federal and state laws existed was in the individual retirement account (IRA) regulations.[22] These differences will necessitate special treatment when the taxpayer withdraws funds invested in an IRA during the period of Georgia's noncompliance as the taxpayer was taxed at the state level on contributions made during that period but was not taxed at the federal level. Thus, this seemingly minor difference between federal and state laws resulted in increased taxpayer's compliance costs and state's administrative costs during that period and will continue to do so for a number of decades.

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[22] Currently, an individual earning income can establish an Individual Retirement Account (IRA) and contribute up to $2,000 per year. (Non-working spouses can make a contribution of $250.) The purpose of establishing such an account is to save for retirement purposes. Provided that individuals do not exceed the income threshold requirements established by the federal government, taxpayers can exempt at least part of their contributions to an IRA from current taxable income. Withdrawals from the account are taxed and, unless they are made according to IRS guidelines, may be subject to penalty. Taxpayers who earn more than the threshold amounts can contribute to an IRA, but only the income derived therefrom is tax-deferred until withdrawal. For 1996, the upper threshold amount for single individuals is $35,000; for individuals filing joint tax returns, the income threshold is $50,000. Phase-out of eligibility for deduction of the contribution from taxable income begins for single individuals at taxable incomes of $25,000; that for married individuals begins at $40,000. When IRA requirements were first applied to all individuals earning income (in 1986), no income thresholds existed, allowing all taxpayers with earnings from wages and salaries or from self-employment to take a deduction for contributions.

Federal law allows states which couple their systems closely with the federal income tax requirements to delegate their individual income tax administrative and collection responsibilities to the federal government (Sunley and Walz, 1986). To qualify, the state must either levy a flat or graduated tax rate on FTI or a flat-tax rate on federal income tax liability. Such an arrangement would significantly reduce the administrative and compliance costs associated with the state individual income tax. The state would forgo the administrative costs of levying and collecting the tax, as well as the costs of audits required to ensure compliance with the state tax requirement. The taxpayer would prepare and submit only one tax return and would be subject to audit from only one government agency. Businesses would report amounts and remit collections for both the federal and state income taxes to only the federal government. The federal government would then remit the taxes paid on behalf of the state's citizens to that state.

One disadvantage to the state that results from delegation of administrative responsibilities to the federal government is that the state government has no control over the requirements for individual income taxes. The state is "held hostage" to federal changes. An extensive change in federal regulations, rates, exemptions, etc., could cause shortfalls in anticipated revenues from individual income taxes and the resultant budgeting problems. Additionally, as the federal government would not receive any portion of state revenues collected from delinquent payment of state taxes, the federal government has no incentive to pursue individuals delinquent on state tax payments. Another objection to this system is that the state would possibly lose employment associated with income tax administration. Thus, although a few states qualify for delegation of their administrative authority to the federal government, no state has chosen this system of individual income tax administration.

Compliance and Administrative Costs

Economists classify the costs of implementing a tax into two categories: (1) compliance costs and (2) administrative costs. Compliance costs of individual income taxes include costs of record keeping, costs of remitting payments to the government on behalf of the taxpayer, any professional or legal fees spent to ensure compliance with governmental requirements and costs of understanding the requirements. Administrative costs of an individual income tax system consist of governmental expenditures for collecting and administering the tax. Both administrative and compliance costs should include direct expenditures, such as legal fees or salaries of governmental workers, as well as any indirect costs, such as overhead and utilities.

From administrative and compliance viewpoints, efficiency in collection and administration are desirable as means to control the money and time outlays of taxpayers and the government. The most efficient system for administering a state individual income tax is for the state to couple their system closely with the federal individual income tax system and delegate responsibility for collection and administration to the federal government. Such a system would result in little incremental record keeping for either the state government or the taxpayer.[23] However, as discussed in the previous section, no state has chosen that option due to its inherent disadvantages, which include loss of state control. State individual income taxes which are not based on federal requirements will produce higher compliance and administrative costs. As a general rule, increased differences between state and federal income tax regulations result in decreased efficiency and increased compliance and administrative costs.

[23] Individuals who earn income in more than one state would have to keep records for all states in which income was earned.

Two alternative ways to gauge the magnitude of administrative costs of the state individual income tax are to consider administrative costs relative to (1) the revenue collected from the tax and (2) administrative costs for other taxes. The individual income tax generates a high proportion of revenue for states. Slemrod and Soren (1984) estimate the costs of collecting federal income taxes as approximately 0.5 percent of revenue collected. Little information exists regarding the administrative costs of state's individual income tax systems. However, for 1996, the state of Georgia budgeted $8.3 million dollars for the section that administers the state's corporate and individual income tax returns. Revenue from the two sources in that year was $732 million and $4,233 million, respectively. If costs were incurred in proportion to the amount of revenue received by the two groups, the estimated direct collection and processing costs for the state were approximately 0.17 percent of revenue. Even if all direct administrative costs were attributed to the individual income tax, direct administrative costs would be less than 0.2 percent of revenue. Unless the state's indirect administrative costs associated with this period are much higher than the direct costs, the state's individual income tax is considerably more efficient than that of the federal government.

Slemrod & Soren (1984) estimate compliance costs averaged $275 per household in 1982, or 14 percent of household income for filing and payment of federal, state and local individual income taxes. Compliance costs on a nationwide basis were estimated at $17 to $27 billion in 1982. Although no estimate of complying with state individual income tax requirements is available, the incremental costs associated with filing these returns increase as differences increase between the state and federal requirements.

A way to examine the differences in compliance costs among states is to look at the complexity of instructions for completing the individual income tax forms. Urbancic (1992) examines the 1990 tax instructions of 15 southern states. In his study, he rates the different instructions using indexes based on sentence and word length. Using one index (the Gunning Fog Index), the instructions for Georgia were rated at a college junior's level of comprehension. Other states ranged in difficulty from high school senior level (South Carolina) to post-graduate level (North Carolina). Using the Flesch Reading Ease Formula, Georgia's instructions were rated 'Difficult.' Both results indicate that simpler verbiage and sentence construction is needed in the tax return instructions to more closely match the skills of the average taxpayer. This simplification would allow taxpayers to complete the required forms in less time and with less assistance, thus reducing compliance cost.

Another way to reduce compliance costs is through the use of electronic filing or by eliminating the need for filing a state income tax return. Georgia allows electronic filing by some taxpayers. As communication of information between different levels of government become more timely, states may permit more taxpayers to reduce their compliance costs by allowing the filing of the federal income tax return to satisfy state filing requirements.

Elasticity

The elasticity of any type of tax refers to the responsiveness of tax revenues to changes in income. Tax elasticity is measured as the percentage change in tax revenue divided by the percentage change in income. A tax can be more or less elastic depending upon the rate structure and tax base. The more elastic a revenue source, the more the revenue increases (decreases) as income increases (decreases). The state individual income tax is a relatively elastic revenue source. For more detail, see the information presented in Box 5.

A number of authors have pointed out the "double-edged sword" of revenue growth and revenue stability. Dye and McGuire (1991) find that a tax with a relatively high elasticity leads to high revenue growth during economic upturns, but also leads to low (or negative) growth during downturns. While state individual income taxes have generally been found to be more elastic than sales taxes, Dye and McGuire (1991) point out revenue growth and variability do not have to go hand-in-hand. A flat-rate income tax can be more stable and faster growing than a narrowly defined sales tax base.

When we evaluate the individual income tax, defining taxable income very broadly results in more stable tax revenues than when certain components of income are omitted. For example, if one state does not tax capital income, as the composition of capital income to total income increases, the percentage change in tax revenue is less than the percentage change in income because the state does not tax the most rapidly growing component of income. The same logic applies to retirement exemptions. As retirement (pension) income increases relative to other forms of taxable income, states that do not tax pensions will be faced with relatively lower elasticities.

Box 5

Example of the Effect of Tax Structure on Elasticity

This example demonstrates the effect of different rate structures on the elasticity of the income tax, using one representative individual. In this example, total income for the individual in 1995 is $29,000. Between 1995 and 1996, the taxpayer's taxable income grows by 5 percent, so taxable income in 1996 is $30,450. Under the progressive structure shown in this example, the total tax due in 1995 is $850; in 1996, it is $931.50. The percentage change in tax liability is 9.6 percent -- certainly larger than the income growth of 5 percent. As additional income faces higher marginal tax rates (or as the average tax rate increases), the tax revenue growth will be greater than the income growth for the taxpayer.

The elasticity benefits of a progressive rate structure slow down over time if the tax brackets are not adjusted. Eventually, the majority of the population reaches the highest tax bracket, so fewer additional dollars are added at the higher marginal tax rate -- rather the additional income is taxed at the same top rate as the last income increase.

TAX STRUCTURE:

Income groups	Tax rates
$ 0-10,000	.01
$ 10,000-20,000	.03
$ 20,000-30,000	.05
$ 30,000-40,000	.07
$ 40,000-50,000	.09
greater than $50,000	.11

Taxable income 1995	$29,000
Tax liability in 1995	$850
Taxable income 1996	$30,450
Tax liability in 1996	$931.50
Percent change in income	5%
Percent change in tax liability (tax revenue)	9.6%
Elasticity	1.92

Economic Development

While the structure, revenue yield, and elasticity of the individual income tax are non-controversial subjects, the effect of income taxes on economic development is *highly* controversial. Most economic studies conducted over the past twenty years found a variety of factors contribute to economic development within a region. Evidence regarding the effect of taxing policies on economic growth is mixed, with some studies concluding that high taxes influence economic development, while other studies find no relationship between tax levels and economic development. Consistency of tax policies and tax trends within an area is thought to positively impact development. The importance of specific factors in location decisions varies among different industries.

Plaut and Pluta (1983) construct a model based on data from 1967-1977 to explain the effects of business climate, taxes, and expenditures on manufacturing growth in the 48 contiguous states. Their results suggest that high tax effort appears to have a negative effect on employment growth. However, the role of taxes is less important than market factors (i.e., land, labor, and energy, etc.) and climate variables.

Bartik, Becker, Lake, and Bush (1987) further supports the conclusions of Plaut and Pluta. Bartik, et. al. conclude that the primary factor affecting the location of the Saturn plant near Nashville, Tennessee was the lower overall projected production costs of that location relative to other sites considered by General Motors. Although their study includes state and local taxes as one component of total cost, the primary determinant of the plant location appears to be the lower labor costs of the area.

Carlton (1979) examines the location choice of firms in three manufacturing industries--plastic products, electronic components, and electronic transmitting equipment. He concludes that wages, technical expertise, proximity to similar companies, and energy costs are the primary factors influencing location decisions; tax rates and policies have little impact on these decisions.

Munnell (1990) suggests that high levels of local public services relative to other regions positively impacts economic development within a region. Tax increases which fund local infrastructure and services, such as education, public safety, transportation network, and local utilities, etc., can positively affect development. However, increased taxes to redistribute income reduce the attractiveness of, and development in a region.

Tannenwald (1996) conducts a careful analysis of the effects of state and local business taxes on business's capital spending. He finds no significant impact of state and local tax burdens on economic development within industries.

Wasylenko and McGuire (1985) conducted a nationwide study covering the period 1973 through 1980 to determine the effect of taxes on employment growth within different industries for Minnesota's tax reform. Their results indicate little correlation between tax effort and employment growth. Furthermore, lower percentage changes in tax effort over time positively affect employment growth rates. An analysis of specific industries shows the individual income tax burden significantly affects employment growth in wholesale and retail trade, finance, insurance, and real estate. Their study concludes that the relatively high individual income tax in Minnesota deterred employment growth, but that any reduction of the income tax should not come at the expense of education, a factor found to positively affect employment growth rates.

Interestingly, later studies by Wasylenko and McGuire (1987) and Wasylenko (1991) find no significant effect of taxes on employment growth but they identify no specific reason for this discrepancy in these studies. However, McGuire (1993) hypothesizes that the convergence of different state tax systems to be more alike in the 1980's may explain the more recent findings. She concludes that consistency and stability in tax policies may impact economic development more than the actual level of taxation.

Voter Response

One of the final questions regarding the individual income tax is the way taxpayers, legislators, and voters feel about the tax. If revenue needs to be raised from some tax, which tax would the voters choose to increase? Through 1994, the U.S. Advisory Commission on Intergovernmental Relations (ACIR) polled a sample of adults annually to determine their attitudes toward governments and taxes. Since 1973, a pattern has emerged regarding responses to the question, "Which do you think is the worst tax--that is, the least fair?" Nationwide, seven to ten percent of individuals judged the state individual income tax to be the worst tax. Box 6 summarizes the responses to this questions for the period 1988 through 1994, the latest year surveyed. Although the question was also asked for the period 1972 through 1987, the social security tax was not an option, causing these results to not be directly comparable with those shown in Box 6. In all years, however, the federal income tax, local property tax and state sales tax are rated worse by higher proportions of individuals, with the two exceptions noted below.

Box 6
Which is the Worst Tax–That is, the Least Fair?

Year	Federal Income Tax	Local Property Tax	State Sales Tax	Social Security Tax	State Income Tax	No Response
1994	27%	28%	14%	12%	7%	11%
1993			Question Not Asked			
1992	25	25	16	10	9	15
1991			Question Not Asked			
1990	26	28	12	15	10	9
1989	21	28	14	18	9	10
1988	26	24	15	17	9	9

Source: ACIR, *Changing Public Attitudes on Government and Taxes*, 1994, Washington, D.C.

For purposes of the ACIR survey, the United States is broken into four areas. The South contains sixteen states and the District of Columbia and encompasses the area from Texas to the Eastern Seaboard northward to include West Virginia, Maryland and Kentucky. The South's results showed that 9 percent of respondents in 1989 rated the state income tax as the worst tax; the perception of the tax deteriorated somewhat by 1992, however, when 11 percent of respondents rated it the worst tax. The image of the state income tax in the South improved by 1994, however, as only 6.7 percent rated the state income tax as the worst tax.

ACIR also provides survey results for different categories of individuals in the nation. Most of the past years' results showed no clear bias against the tax by one income group relative to another. However, in 1993, 21 percent of individuals in the income range of $25,000 to $29,900 rated the tax as worst, versus less than 10 percent for all other income groups. In 1994, however, 12.3 percent of those with incomes in the range $30,000-$39,900 rated the income tax as worst; less than 9 percent of respondents in all other income categories rated the state income tax as worst.

In the 1993 survey, another group which rated the state income tax worse than other categories of individuals was the professional/manager/owner category. The results indicated over 23 percent of these individuals rated the state income tax as worst, with only 13.9 percent of respondents in this category rating the state sales tax as worst. However, in the 1994 survey, the results for this category mirrored the overall pattern, with 7.6 percent rating the state income tax as the worst versus 12.1 percent rating the state sales tax as the worst tax.

When faced with alternative tax packages, voters do not necessarily choose the package that the ACIR poll's results might cause one to expect. For example, in 1994, in an effort to raise an additional $4.2 billion in revenue, the ballot presented two options to Michigan's voters: (1) raise the state sales tax rate from 4 to 6 percent and increase the cigarette tax by 50 cents or (2) raise the income tax. The taxpayers chose the first alternative. The results of the 1994 ACIR poll indicated that 4.9 percent of the individuals in the North region rated the income tax as the worst tax versus 15.2 percent who rated the state sales tax as the worst tax. However, Michigan voters voiced their preferences at the polls for a higher state sales tax, an outcome not at all consistent with that of the ACIR poll.

In all results reported by ACIR, a higher percentage of individuals consistently voted the property tax as the worst tax compared to those who voted the state income tax as the worst tax. This result applied, regardless of income, race, region of the country, or profession of the individuals polled. These results might lead one to expect that, when given a choice, individuals would prefer an increase in income taxes to allow a reduction in property taxes. However, results from a poll taken in late 1996 by the University of North Dakota's Bureau of Governmental Affairs showed that the majority of those polled preferred just the opposite. The impetus for this poll was a proposal advanced during the interim legislative sessions to raise income taxes for school funding and to allow a reduction of property taxes.

Possible explanations for these two inconsistencies with ACIR's findings could be one or more of the following factors: (1) ACIR's results may be too general to reflect the preferences of residents of a specific state, such as Michigan or North Dakota, which has a small population relative to that of the area designated "north"; (2) individuals may respond differently when one tax is directly pitted against another tax rather than when a more general question is posed (such as that asked by ACIR); (3) individuals are inherently resistant to change and may simply be reluctant to change the tax structure; and (4) as property taxes are commonly used to finance education, taxpayers may see alternative tax structures as inappropriate.

Another indication that voters have a "tolerance threshold" for state income taxes is the defeat of Proposition 217 by California voters in the November, 1996 election. That proposition would have reimposed the 10 and 11 percent income tax brackets in the state. In some ways, the defeat of the measure was surprising, as it did not directly affect most voters.[24] One possible explanation for the unpopularity of the measure is that voters may be convinced that the high marginal tax rates discourage higher-income individuals from living or from doing business in the state.

The preferences of Georgia's legislature for the state income tax versus a state sales tax will be tested in 1997 when they vote on HB 8. This measure would gradually phase out the individual income tax and raise the state sales and use tax from the current 4 percent level to 6.5 percent on or after January 1, 2002. If approved, the resulting overall state tax structure would have little or no progressivity and would closely mimic those of two of Georgia's neighbors--Florida and Tennessee. The popularity of this bill appears limited, however, as it had not reached the House floor for a vote as of mid-March, 1997.

[24] The 1996 threshold taxable income levels for the 10 percent bracket were $111,695 for single taxpayers, with double that amount for married filing jointly. According to information compiled by Citizens for Tax Justice (1996) for tax year 1995, the top 20 percent of taxpayers had incomes of $80,000 and up, leading to a conclusion that less than 20 percent of the state's taxpayers would be directly affect by these two tax brackets.

Lottery Winnings

From time to time, changes in state revenue structures affect the income tax. The increased use of state lotteries is one such change. When the Georgia legislature authorized a lottery for the state, no regulations were concurrently adopted governing taxation of winnings received by nonresidents. This deficiency in the Georgia tax code resulted in some significant winnings not being taxed as income at the state level. Effective for tax years beginning on or after January 1, 1994, all winnings exceeding $5,000 are subject to withholding by the State Revenue Commission. Effective March 29, 1994, lottery prizes awarded to nonresidents became includable in Georgia taxable income and taxable as such.[25] With the increase in lotteries throughout the U.S., other states have adopted similar requirements for taxation of winnings.

Non-residents and Partial-year residents

Finally, many states grapple with the issue of the taxation of non-residents. Federal law allows states to tax income earned in the state by nonresidents, but prohibits taxing of other income earned by nonresidents. Most states have provisions whereby credits are granted on taxes paid to other states.[26] However, any income earned by residents of their states in other states may be subject to taxation in both states. Depending on how a state determines the amount of income allocable to the state, the taxpayer could effectively face a penalty for generating income in more than one state.

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[25] Act 816 (H.B. 1369), approved March 25, 1994, authorizes the State Revenue Commissioner to provide regulations defining withholding requirements for lottery winnings. Act 912 (H.B. 1368) specifies the requirements for taxing nonresident's net income from lottery prizes.

[26] Some states have agreements with specific states whereby income is taxed in the state of residence, regardless of where it is earned. Generally, these agreements are between two neighboring states. Neither Georgia nor its neighbors have entered such an agreement; the practice is prevalent in the Midwest and the East.

Box 7 shows the computation of Georgia income tax for a partial-year resident and underscores the complexity that can arise from different treatment among the states.

In recent years, some states have enacted legislation to more clearly define activity that constitutes earnings within the state. One example of activity that needed clarification was the definition of the taxing jurisdiction for celebrities who earn significant fees for one-time appearances in a state. Prior to the different states enacting legislation, the individuals' states of residence were the only taxing jurisdictions. In some cases, however, no state received personal income tax revenues from the individuals' earnings. An example of such an activity is the participation of the Dallas Cowboys in the Super Bowl played in Atlanta, Georgia in 1994. As Texas levies no personal income tax, in the absence of any specific Georgia legislation, the participants' earnings would not be subject to individual income taxation in Georgia or Texas.

Box 7
Comparison - Taxation of Residents vs Partial-Year Residents
For the Tax Year 1996 State of Georgia

Practices vary

Description (married, joint)	6-Month Georgia Resident	Full-Year Georgia Resident
Federal AGI	$ 20,000	$ 20,000
Georgia AGI	$ 10,000	$ 20,000
Georgia's claim	50%	100%
Georgia Standard Deduction	$ 1,500	$ 3,000
Georgia Personal Exemption	$ 1,500	$ 3,000
Georgia Taxable Income	$ 7,000	$ 14,000
Georgia Income Tax	$ 192	$ 583

[1] AGI Adjusted gross income.

Source: CCH, Inc., *State Tax Guide*, 1997.

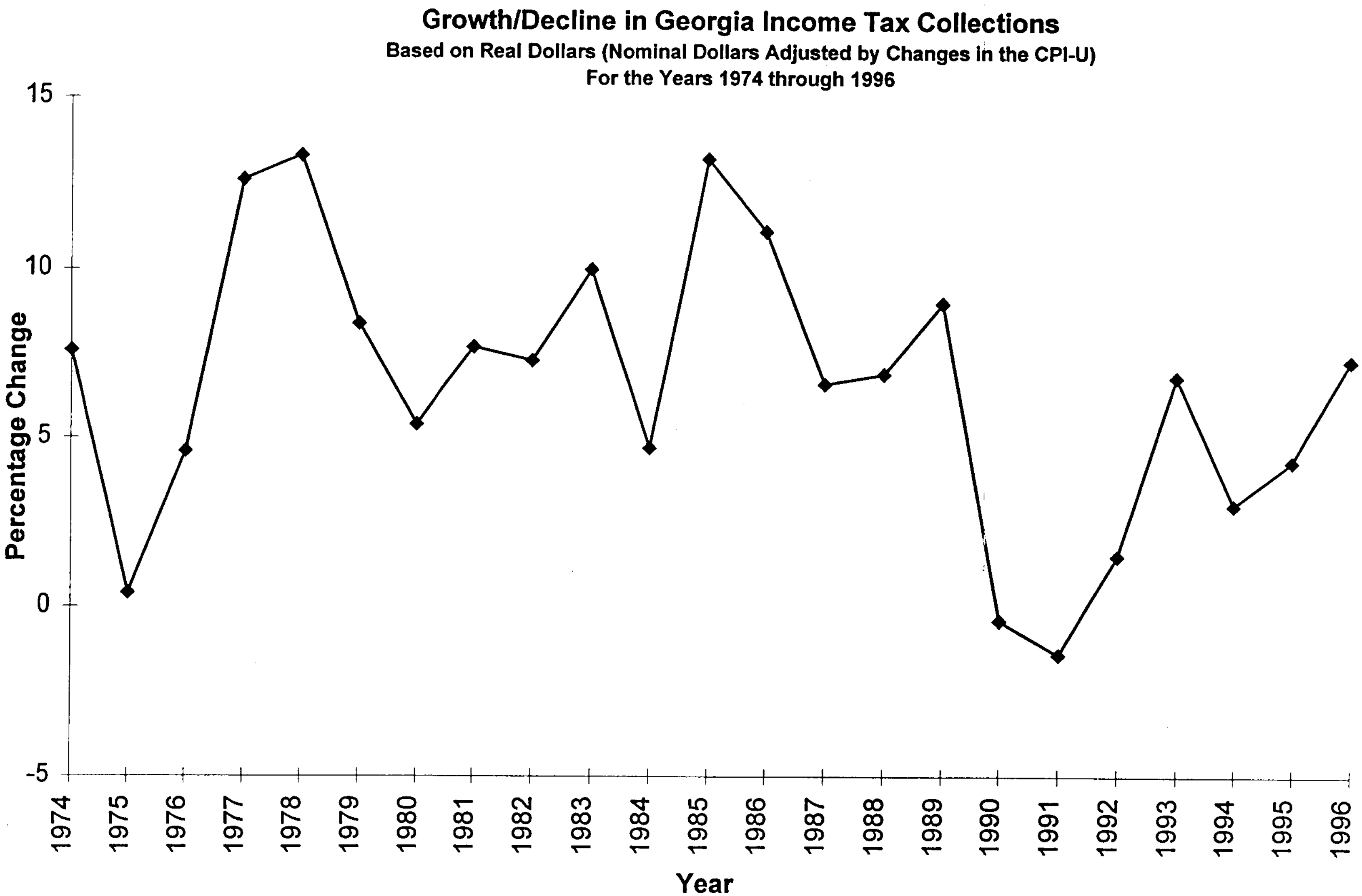
III. HISTORY AND USE OF GEORGIA'S INCOME TAX

Background

The Georgia individual income tax was first imposed in 1929. While it has been changed over the years, the same basic structure has existed since 1937. The last major set of adjustments occurred in 1987, when Georgia's exemptions and standard deductions were changed to match those of the federal government for that year.

The annual growth in the individual income tax has shown the tax to be a fast-growing revenue producer. As Figures 1 and 2 show, the real growth in personal income tax revenues in Georgia generally follows the same growth trend as that of real personal income. As these figures show, however, percentage growth of the personal income tax is generally greater than that of personal income. Since the mid-1980's, the growth rate of the personal income tax has been lower than the rate was in prior years. Two discretionary changes to Georgia's individual income tax code partly explain the slowed rate of growth. First, in 1987, Georgia increased its personal exemption amount and adjusted its standard deduction rules. Second, Georgia's retirement income exclusion was increased in 1986, 1989, 1990, 1994, and 1995. The effects of both these changes were to shrink the personal income tax base, somewhat offsetting any growth in real personal income. Underlying economic and demographic factors that may also have contributed to the slowdown in the rate of growth of the personal income tax revenues are the changing composition of personal income and the increasing share of the elderly in the total population. Recessionary periods also show a marked decline in the growth of personal income and the personal income tax. In real terms, a decline in income tax collections, rather than growth, occurred in 1990 and 1991.

Figure 1



Growth/Decline in Georgia Income Tax Collections
Based on Real Dollars (Nominal Dollars Adjusted by Changes in the CPI-U)
For the Years 1974 through 1996
Percentage Change
15
10
5
0
-5
1974
1975
1976
1977
1978
1979
1980
1981
1982
1983
1984
1985
1986
1987
1988
1989
1990
1991
1992
1993
1994
1995
1996
Year

Figure 2

Growth/Decline in Georgia Real Personal Income
(Nominal Amounts, as Adjusted by CPI-U)
For the Years 1974 Through 1996

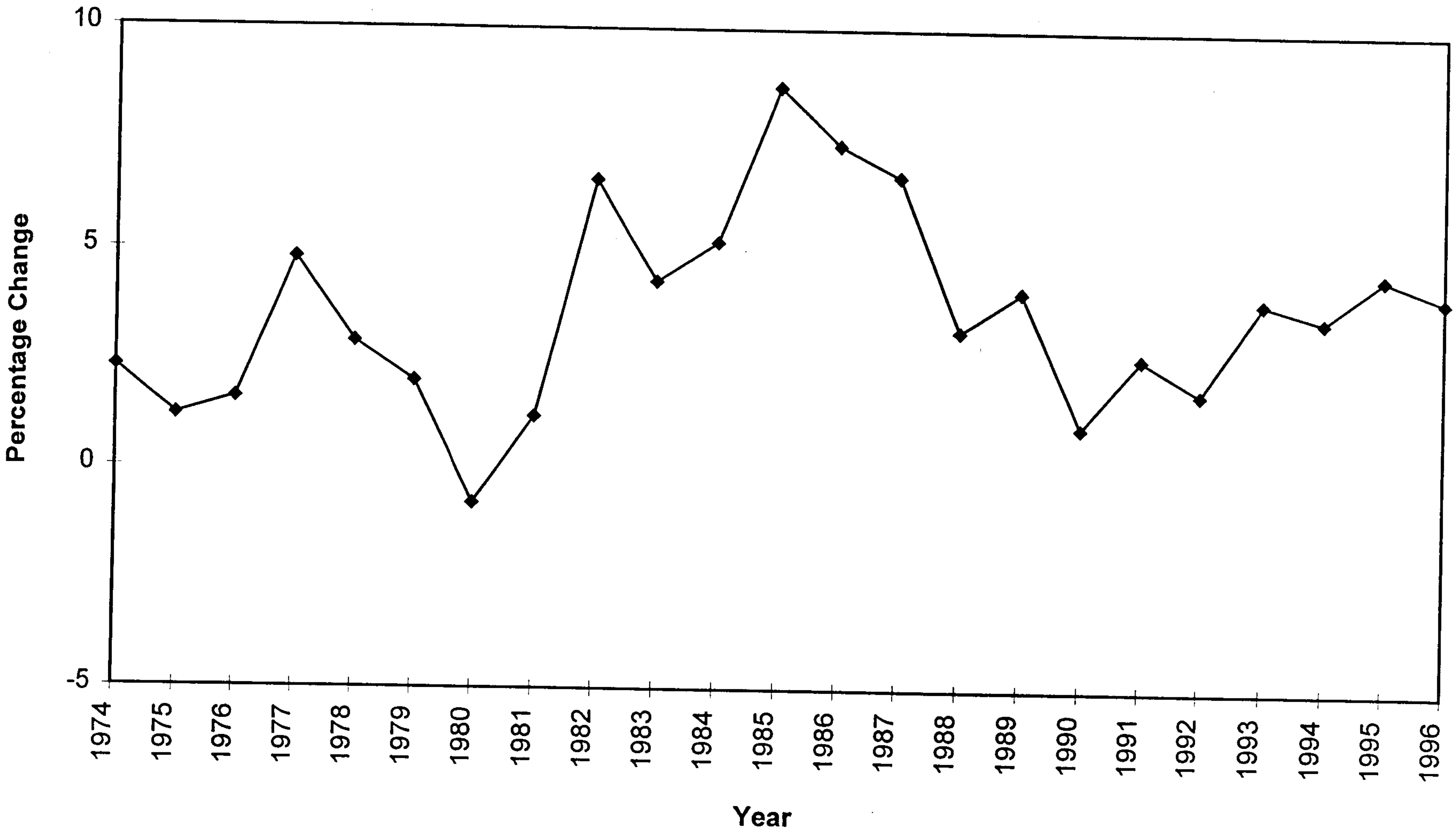


Figure 3 shows four of the main sources of income as a share of total personal income for the period 1980 to 1994.[27] Transfers, which are largely untaxed under the Georgia personal income tax code, have risen rapidly since 1989 to be the highest share of total income of the four sources shown. A related phenomenon illustrated in Table 9 is the increasing share of the elderly. The share of Georgia's population that is over 65 increased from 9.5 percent in 1983 to 10.0 percent in 1995. The major components of transfer payments are retirement and disability insurance payments, medical payments, veterans' benefit payments, income maintenance benefit payments, payments to nonprofit institutions, and unemployment insurance benefit payments. As the elderly population in Georgia grows, these non-taxable forms of income are also expected to grow. Although the main source of earnings for the elderly is retirement income, which is largely exempt from taxes, a sizable portion of transfers represents payments to or on behalf of the elderly. Another factor which contributes substantially to the increase in transfer payments is the increase in the number of public assistance recipients in Georgia. The increase in transfer payments in Georgia from 1980 to 1994 averaged over 8.8 percent compounded annually, versus slightly over 8.0 percent for the United States in total (Bureau of Economic Analysis, 1994).

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[27] The other major source of personal income is wages which have been more or less a constant 70 percent of total personal income over the period shown.

Figure 3

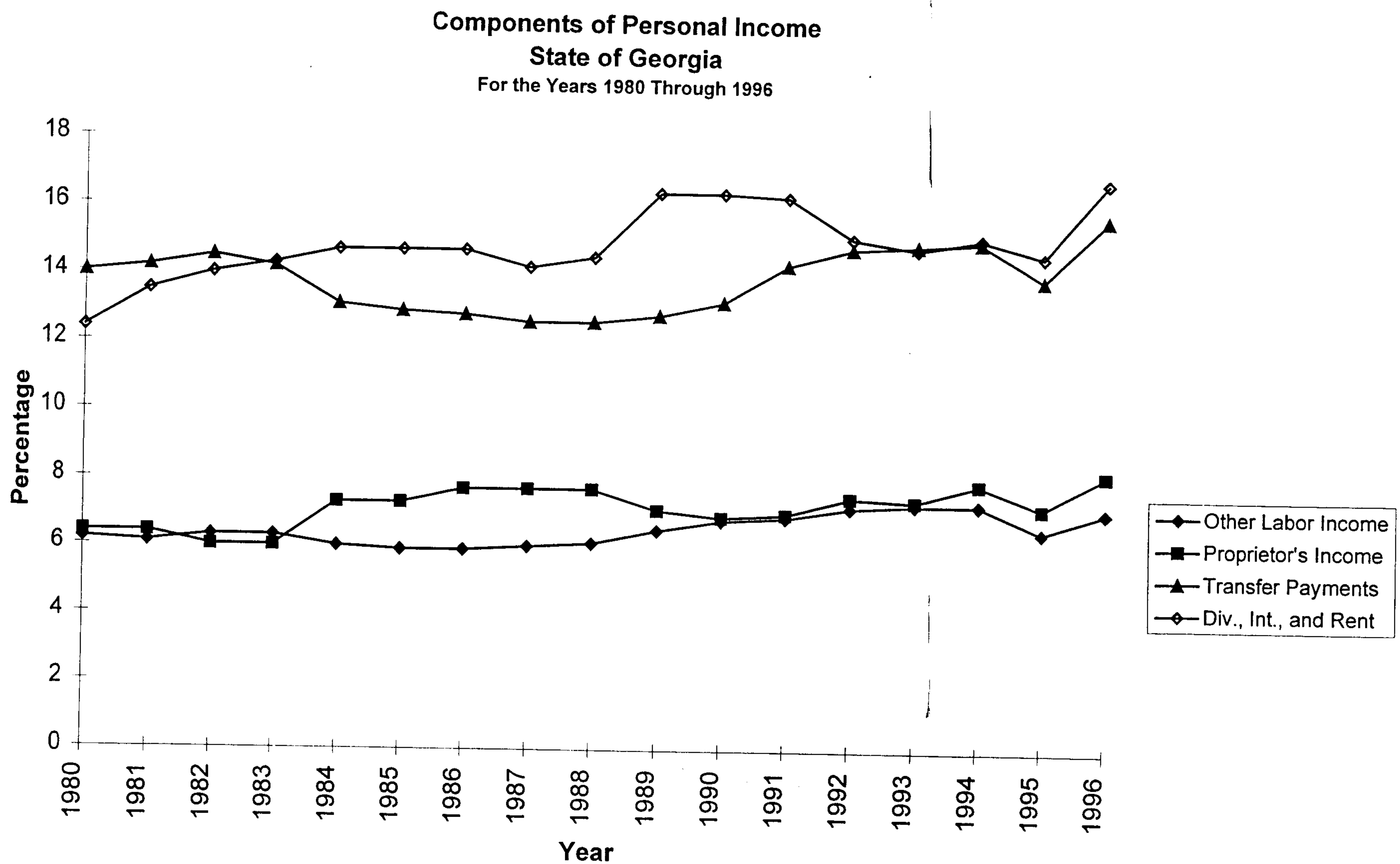

Components of Personal Income
State of Georgia
For the Years 1980 Through 1996
18
16
14
12
10
8
6
4
2
0
Percentage
1980
1981
1982
1983
1984
1985
1986
1987
1988
1989
1990
1991
1992
1993
1994
1995
1996
Year
Other Labor Income
Proprietor's Income
Transfer Payments
Div., Int., and Rent

TABLE 9
AGE DISTRIBUTION OF THE POPULATION, 1980 AND 1995

	1980		1995	
Age	Georgia	United States	Georgia	United States
0 to 4	7.6%	7.2%	7.6%	7.5%
5 to 17	22.5%	20.9%	19.1%	18.7%
18 to 24	13.4%	13.3%	10.1%	9.5%
25 to 34	17.0%	16.4%	16.9%	15.5%
35 to 44	11.8%	11.2%	16.7%	16.2%
45 to 54	9.7%	10.1%	12.1%	11.8%
55 to 64	8.5%	9.6%	7.5%	8.0%
65 & older	9.5%	11.3%	10.0%	12.8%
Total	100.0%	100.0%	100.0%	98.8%

Source: U. S. Bureau of Census, Internet Site, http://www.census.gov/.

Importance of Georgia's Individual Income Tax

As is true in many states, the individual income tax in Georgia increased as a percent of total state tax revenue from 33.1 percent in 1976 to 43.9 percent in 1996. Figure 4 shows the importance of the state individual income tax as a revenue source in Georgia and for all states. While the ratio of individual income tax to total state revenue has decreased in some years, the general trend in its growth has been upward.

In most states, the personal income tax is largely a state-level revenue source. Georgia law allows a local income tax but such a tax has never been instituted.[28] When compared with specific state revenue sources in Georgia, the income tax constitutes the largest category of own-source revenue, followed by the state general sales tax. As seen in Table 10, the individual income tax constituted 26.8 percent of state own-source revenue in FY 1996. Federal intergovernmental revenue, however, contributed 30.5 percent to the state's revenues. If we examine the different taxes

[28] The statute allows *either* a local option sales tax *or* a local income tax to be levied by local governments, but not both.

relative to all state and local revenue, the income, property, and sales tax each constitute a large portion of total revenue. Table 11 shows the income tax as a percent of different revenue measures. The lower percentages of the income tax based on state-local measures relative to state revenue measures reflects the fact that the income tax does not contribute to local revenues.

TABLE 10
DISTRIBUTION OF STATE GENERAL REVENUE, 1995
($ Millions)

Source	Amount	Percent of Total
Total General Revenue	$17,122.8	100.0
Intergovernmental Revenue	5,223.6	30.5
Total Own Source	11,899.2	69.5
Taxes	9,486.6	55.4
General Sales	3,538.7	20.7
Individual Income	4,591.2	26.8
Corporate Income	653.3	3.8
Other	703.4	4.1

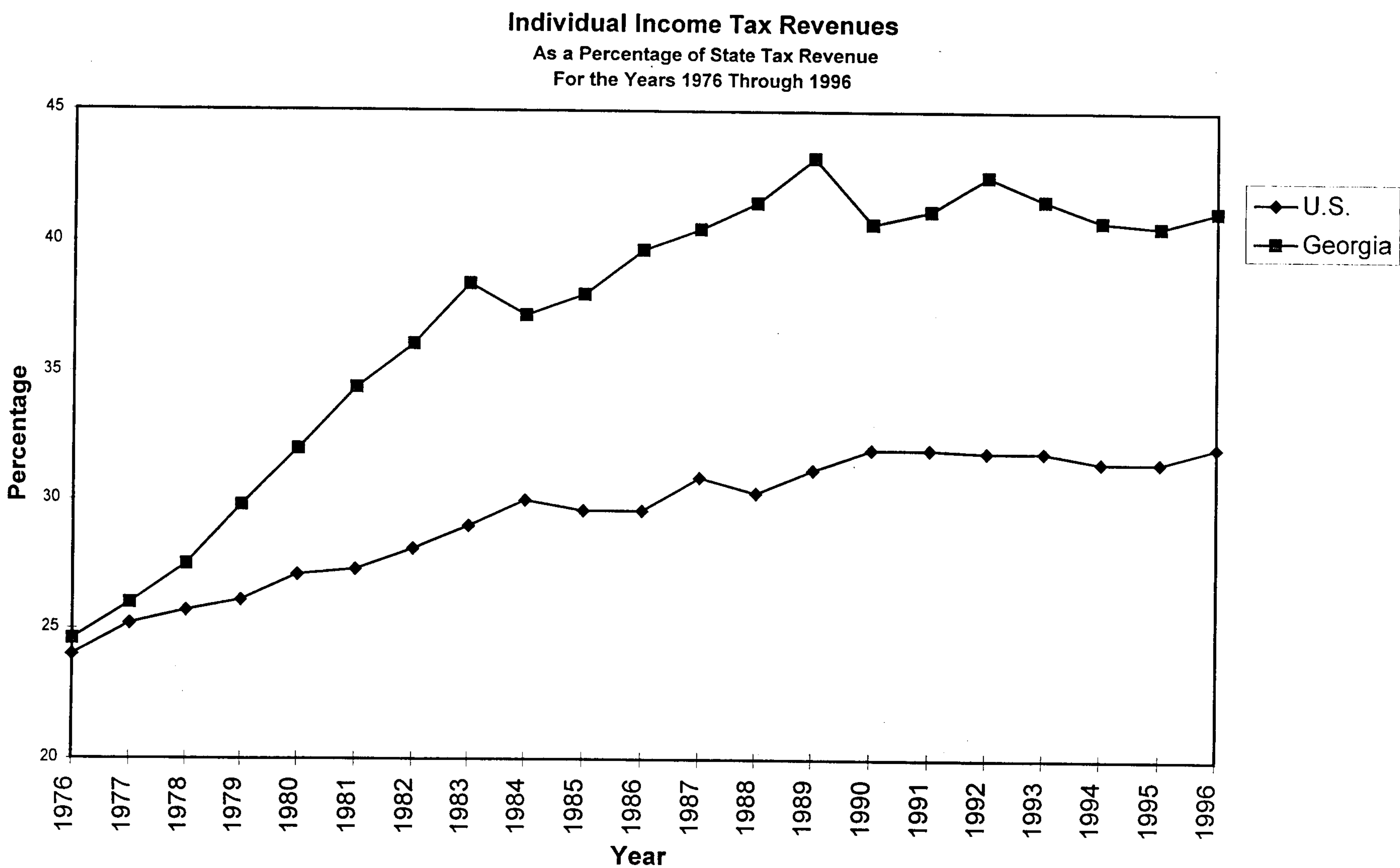
Source: U. S. Department of Commerce,Internet Site, http://www.census.gov (accessed 3-17-97).

TABLE 11
GEORGIA INDIVIDUAL INCOME TAX REVENUE AS A PERCENT OF:

	Total State General Revenue	Total State-Local General Revenue	Total State Taxes	Total State-Local Taxes
1970	10.9%	6.8%	18.7%	11.9%
1980	17.0	9.7	28.9	18.7
1993	20.5	15.1	41.6	27.4

Source: ACIR, *Significant Features of Fiscal Federalism*, and U.S. Department of Commerce, *Government Finances*, various years; Tax Foundation, *Facts and Figures on Government Finance*, 1995.

Figure 4


Individual Income Tax Revenues
As a Percentage of State Tax Revenue
For the Years 1976 Through 1996
45
40
35
30
25
20
Percentage
1976
1977
1978
1979
1980
1981
1982
1983
1984
1985
1986
1987
1988
1989
1990
1991
1992
1993
1994
1995
1996
Year
U.S.
Georgia

Distribution of the Tax Under Current Law

The distribution of the Georgia personal income tax is shown in Table 12. The data in the table present the tax as a percentage of Federal AGI (FAGI) by income groups based on FAGI.[29] These results were obtained from a microsimulation model (see Technical Appendix) of the current Georgia tax code using a 2 percent sample of the 1993 tax returns obtained from the Georgia Department of Revenue. While the lowest income groups, $5,000 and under, pay no personal income tax, the tax is very progressive over the low- to middle-income range, with the tax as a share of income rising relatively quickly from 0.8 percent for the income group $5,000 - $10,000 to 3.51 percent for the income group $25,000 - $35,000. The tax is slightly less progressive over the middle- to high-income range, rising gradually from 3.51 to 4.04 percent of FAGI for the income group $50,000 - $75,000. The tax then rises relatively quickly in the high-income range from 4.04 to 4.61 percent of FAGI for the income group over $100,000. The overall effect is a fair degree of progressivity for the Georgia personal income tax. This progressivity is achieved by a combination of the standard deduction, exemptions, the low-income credit, and a graduated rate structure.

[29] Non-residents and partial year residents are not included as FAGI is not available for these filers.

TABLE 12
DISTRIBUTION OF PERSONAL INCOME TAX IN GEORGIA, 1996 LAW
(1993 Levels)

Income Class[1]	Number of Filers	1996 Law: Tax Burden[2]
Less than $1,000	72,000	0.01
$1,001 - $5,000	298,500	0.01
$5,001 - $10,000	376,400	0.80
$10,001 - $15,000	354,100	1.91
$15,001 - $25,000	540,250	2.92
$25,001 - $35,000	342,950	3.51
$35,001 - $50,000	359,650	3.83
$50,001 - $75,000	279,100	4.04
$75,001 - $100,000	86,750	4.22
More than $100,000	81,250	4.61
Total	*2,790,950*	*3.55*

[1] Federal Adjusted Gross Income.
[2] "Tax burden" is measuring as income taxes paid divided by total FAGI.

A rough comparison of Georgia with some neighboring states[30] (with the difficulties outlined in the discussion above duly noted) reveals that Georgia has less progressivity than its neighbors with respect to the personal income tax. For those Southeastern states with a personal income tax, three states, Alabama, Kentucky, and Louisiana show regressivity over some income ranges. Alabama is, by far, the state with the least progressive structure with the lowest 20 percent income group paying a tax of 1.8 percent of income which then rises to 2.8 percent of income for those in the second income quintile and is proportional over the third and fourth income quintiles at 3.2 percent and shows regressivity throughout its top quintile. Georgia was the only other southeastern state to have any proportionality in its personal income tax structure. All other states showed progressivity throughout their structures (except Tennessee, where the personal income tax is so small as to be insignificant). South Carolina had the most progressivity in its structure over the lowest four income

[30] Citizens for Tax Justice, 1996.

quintiles, with the lowest income quintile paying only 0.1 percent in income taxes; taxes as a share of income rise gradually to 3.8 percent of income for those in the 60-80 percent income group. North Carolina has the highest tax burden from the personal income tax of any southeastern state with the top 1 percent of income earners paying 6.2 percent of their income in personal income taxes. However, it has about the average amount of progressivity of the group at all income levels except the top five percent of income group.

When we compare the southeastern states to the U.S. averages, we see that all of these states except Alabama and Virginia have more progressive personal income tax structures between the two lowest income quintiles. Georgia had less progressivity than the U.S. averages over all other income ranges and, in general, the southeastern was less progressive at the highest income levels than the U.S. averages.

Elasticity

The Georgia individual income tax has been fairly elastic over time. Early estimates by Feenberg and Rosen (1986) estimate that the elasticity of Georgia's state government individual income tax was 1.47 in 1983. This means that in Georgia, as income grew by 1 percent, state individual income tax revenue grew by 1.47 percent, making for a relatively elastic tax. Estimates of the elasticity by the Georgia Department of Revenue since then reveals that the tax has remained relatively elastic (Gold, 1995).

Table 13 shows the results of estimating the revenue elasticity with respect to income. These results were obtained by finding the change in tax revenues which arises from a simulated 5, 10, and 15 percent increase in personal income using the 2-percent sample of 1993 returns and the tax calculator from the microsimulation model of the Georgia personal income tax (see Appendix A). These results show that while the tax is elastic, it is slightly less so than earlier estimates.

TABLE 13
ESTIMATE OF THE REVENUE ELASTICITY

Income Change (%)	Revenue Change (%)	Elasticity (%)
5.0	6.80	1.3595
10.0	13.62	1.3623
15.0	20.47	1.3644
Average:		*1.3620*

Source: **Calculation of authors using the Georgia State Individual Income Tax Simulation Model.**

A more detailed look at the determinants of elasticity will shed some light on the reason for the relatively elastic nature of the Georgia personal income tax. Revenue elasticity is calculated in two parts: (1) the *rate* elasticity, which measures how revenue changes with changes in *taxable income* and (2) the *base* elasticity, which measures how taxable income changes with changes in *personal income* or some other comprehensive measure of income. Due to the economic and demographic changes which caused Georgia's taxable income to grow more slowly than personal income, we can conclude that the base elasticity of the income tax is relatively inelastic. Thus, rate elasticity explains the relatively elastic nature of the income tax. The progressivity of the income tax provides a partial explanation of the effects of rate elasticity. Effective tax rates rise rapidly as taxpayers' incomes increase. Our analyses show that the Georgia taxpayers' income distribution currently covers the range of the graduated rate structure. However, as more taxpayers are pushed into the higher brackets due to inflationary growth in incomes, lower revenue elasticity will result. The customary methods of offsetting these effects is to index income brackets, standard deductions, and exemptions to inflation so revenue elasticity remains more or less constant over time. Georgia has not regularly followed these practices in the past.[31]

An important issue related to revenue elasticity is revenue stability over the business cycle. Although the high revenue elasticity is good news during periods of economic upturns, it can lead to significant decreases in revenues during economic downturns. In the case of the personal income tax, instability can be reduced by defining income as broadly as possible. For example, retirement income, such as social security payments, is fairly constant over the business cycle. Excluding it from the tax base therefore excludes an element of stability. However, this issue is better treated in a discussion of the overall tax structure of the state as the overall fiscal position can be stabilized by the judicious choice of taxes.

IV. RECENT CHANGES TO GEORGIA'S INDIVIDUAL INCOME TAX

The Role of Federal Legislation

Over the last few decades, Georgia has modified its individual income tax in a number of ways. The Georgia Assembly adopted the Internal Revenue Code in effect on January 1, 1981. Georgia allowed for adjustments to FAGI for such items as retirement income and interest on federal obligations and other states' obligations.

While Georgia was very similar to the federal income tax in 1981, the Tax Equity and Fiscal Responsibility Act (TEFRA) of 1982 contained additional changes to individual's federal income tax requirements. As a result, as of 1982, Georgia and the federal income tax became quite different.

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[31] Recall that in 1987, Georgia coupled to the federal standard deduction and personal exemption amounts, but did not change those levels until 1994. The only change at that time was to the personal exemption amount allowed for dependents.

Georgia's 1982 tax return detailed the major areas where Georgia and federal requirements differed. The data in Table 14 contain these differences.

Subsequent federal changes in 1984 and 1986 led to a divergence between the federal income tax code and the income tax code in Georgia. In 1987, the General Assembly updated the Georgia Income Tax Code to closely follow the Internal Revenue Code of 1986.

The Standard Deduction

In 1983, Georgia's standard deduction amounts increased for all taxpayers. Lower and upper standard deduction limits were integral to the structure and resulted in individuals in the lower income brackets not receiving the full benefit of the standard deduction. With this structure, the taxpayer could not simply select the amount of standard deduction to use. Instead, the taxpayer had to calculate an amount based on percentages of income and compare it to the limits. In the Georgia tax reform of 1987, the lower/upper limit concept was eliminated and a single deduction amount for each category of taxpayer (e.g., single, married-joint, married-separate) was adopted. The deduction amount was the upper limit amount previously used. Those standard deduction amounts remain in effect, with $2,300 allowed for single taxpayers; $3,000 allowed for a married couple filing a joint return; and $1,500 allowed for a married couple filing a separate return. An additional $700 deduction is allowed for a taxpayer and/or spouse who is blind or a taxpayer and/or spouse that is aged 65 or older.

Exemption Amounts

The 1987 changes also increased the exemption for dependents from $700 to $1,500. For taxable years beginning on or after January 1, 1994, the exemption amount per dependent was increased to $2,000. The same legislation provided for a further increase of the dependent's exemption amount to $2,500 for taxable years beginning on or after January 1, 1995. The exemptions amounts for each taxpayers remains at $1,500, the same level as that adopted for tax year 1987.

Retirement Income Exemptions

In 1983, the General Assembly first addressed a broader issue of taxability of retirement income and allowed individuals deductions of up to $2,000 of retirement income from all sources. The dollar limit was doubled to $4,000 in 1986, again doubled to $8,000 in 1989, and raised to $10,000 in 1990. Effective for tax years beginning on or after January 1, 1994, the limit per individual was raised to $11,000. The same legislation provides for an increase in the limit per individual to $12,000 effective for tax years beginning on or after January 1, 1995. With the more recent increases, certain retirement income that was previously exempted from Georgia AGI was not specifically exempted, but was included in the broad heading of "retirement income".

TABLE 14
DIFFERENCES BETWEEN FEDERAL AND STATE INCOME
TAX REGULATIONS, 1982

PROVISION	FEDERAL 1982	GEORGIA 1982
Deduction for Two-Earner Married Couples	Deduction of 5 percent of spouse with the lower qualified earned income, with maximum deduction of $1,500.	Deduction not allowed.
Dividend & Interest Exclusion	Reverts back to $100/$200 exclusion and includes only dividends.	Applied to regular dividends, interest and/or interest on Qualified Savings Certificates; Maximum of $200/$400.

PROVISION	FEDERAL 1982	GEORGIA 1982
Qualified Savings Certificates (All Savers)	$1,000/$2,000 lifetime exclusion on interest earned.	No similar exclusion; dividend and interest exclusion are as noted above.
Taxation of Unemployment Benefits	Reduction in base from $20,000/$25,000 to $12,000/$18,000.	Apply federal guidelines, with base of $20,000/$25,000.
Individual Retirement Accounts (I.R.A.)	Removed restriction on qualified plans and increased deduction to $2,000 per individual and $2,250 for spousal.	Taxpayer could not be covered under an employer-sponsored plan; maximum $1,500/$1750.
KEOGH, SEP and SUB S Plans	The lesser of 15 percent or $15,000.	$7,500 maximum.
Child and Dependent Care Credit	Eligible expenses increased to $2,400 for one and $4,800 for two or more qualifying individuals.	No changes made.
Sales/Exchanges of Residences by Taxpayers Age 55 and Over	Exclude up to $125,000, with $62,500 for married filing separately.	Exclude up to $100,000; $50,000 for married filing separately.
Sales or Exchanges of Residences	Replacement period increased to 24 months.	Replacement period remained 18 months.
Depreciation	Accelerated cost recovery system allowed.	Allowed depreciation methods prior to 1-1-81 (not ACRS).
Adoption Expense	Allowed up to $1,500 of qualified expenses.	No deduction allowed.
Foreign Earned Income	Increased by ERTA (1981) to $75,000 for qualified individual (330 days in 12 consecutive months).	Limited to $20,000 (510 days in 18 consecutive months).
Dependent care assistance to employees	Excluded amounts paid by employers for furnishing dependent care assistance.	No provision.
Dividend Reinvestment Plans	Stockholders of qualified domestic public utilities may exclude up to $750/$1,500 of stock dividends from income.	No provision.
Charitable Deductions When Taxpayer Not Itemizing Deductions	Allowed up to 25 percent of $100.	No provision.
Net Operating Loss	Carryforward extended to 15 years for taxable years after 1975.	Carryforward for 7 years.

Tax Credits

From 1984 through 1986, Georgia allowed a solar energy income tax credit. Carryover of any unused credits was allowed in 1987. In 1992, new state legislation allowed credits to benefit lower income and/or unskilled workers, and development activity in Georgia's least developed counties. The Business Expansion Support Act of 1994 expanded the provision for tax credits afforded in the 1992 legislation and includes provisions for tax credits to businesses increasing employment and making capital investments above specified threshold levels in economically distressed areas. The Act also grants tax credits to employers for providing child care services and retraining programs. To encourage physicians to practice in rural areas, a tax credit not to exceed $5,000 can be used for up to five years, subject to certain requirements. This provision was adopted for physicians who began practicing in rural counties after July 1, 1995 and was first available for those filing for tax year 1996.

The only significant individual income tax legislation adopted in Georgia that affects credits and that goes into effect on January 1, 1997 is the credit granted for qualified water conservation investments or the purchase of water from such a facility. This tax credit will affect only a small number of taxpayers, however, and will have no negligible effect on the state's revenues from the personal income tax.

In summary, the current Georgia individual income tax requirements closely mirror the federal requirements. Notable exceptions are the retirement income exclusion, credits to benefit development or business activity in lower-income counties, credits for lower-income individuals, credits for specific employee benefits provided by employers, tax credits to encourage water conservation, and adjustments to compensate for the differences between Georgia and federal requirements for the tax years 1981 through 1986. The largest changes made to the system in Georgia in the past decade occurred when the federal government passed the Tax Reform Act of 1986. While a number of changes have since been made, they have been relatively small. These other changes are discussed in detail in Appendix B.

V. COMPARISONS WITH OTHER STATES

The state of Georgia has a relatively high reliance on the individual income tax. Figure 5 shows state individual income tax as a percent of total state tax revenue for the U.S. and the Southeastern states for 1995. Virginia and North Carolina are the only Southeastern states with a heavier reliance on the individual income tax than Georgia. As mentioned above, this reliance on the income tax has increased somewhat over the last two decades.

A comparison of the base and rate structure of Georgia with some neighboring Southeastern states is found in Table 15.

TABLE 15
INDIVIDUAL INCOME TAX BASES AND RATES
COMPARISON OF GEORGIA WITH SOME NEIGHBORING STATES, 1996

State	Base	Deductions	Exemptions	Income Brackets and Ranges Within Brackets	Rates
Alabama	FAGI	-itemized deductions (fed. law) *or the lesser of* -standard deduction (20% of AGI) or $2,000/single; $4,000/married-joint	$1,500/single *or* $3,000/ married-joint *plus* $300 per dependent	*3 Brackets* -- $500-3,000/single, head of family, married-sep; $1,000-6,000/ married-joint	2 - 5%
Arkansas	Income and adjustments determined by state law	-itemized deductions (state law) *or the lesser of* -standard deduction (10% of AGI) *or* $500/married-sep; $1,000/single, married-joint	$20 tax credit per each exemption	6 *Brackets* $2,999-25,000/all taxpayers	1 - 7%

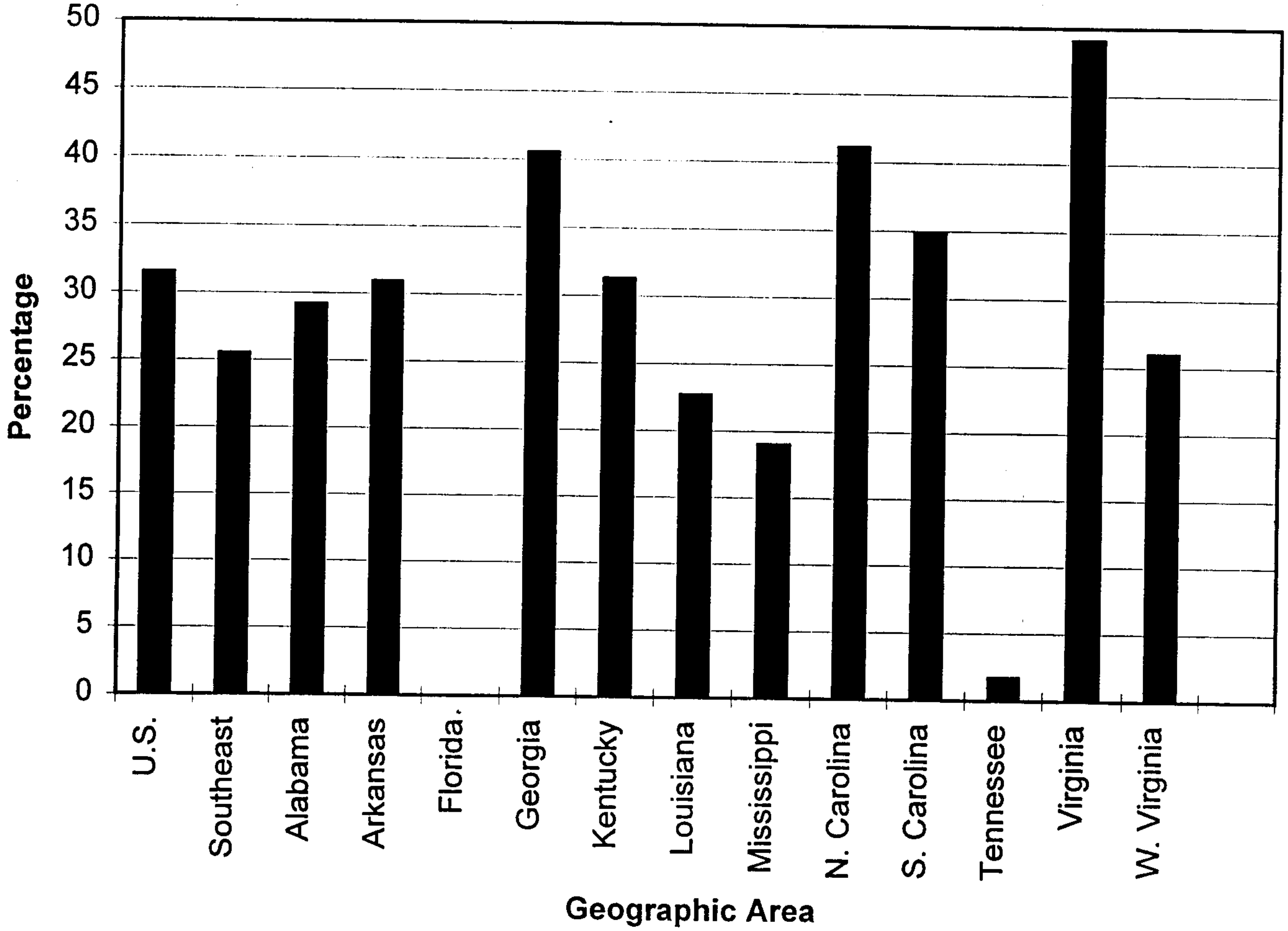
TABLE 15
INDIVIDUAL INCOME TAX BASES AND RATES
COMPARISON OF GEORGIA WITH SOME NEIGHBORING STATES, 1996

State	Base	Deductions	Exemptions	Income Brackets and Ranges Within Brackets	Rates
Georgia	FAGI	-itemized deductions (fed. law) *or* -$1,500 married-sep; $2,300/ single; $3,000/ married-joint	$3,000/single; married-joint; $1,500/married-sep *plus* $2,500 per dependent	*6 Brackets* $500-5,000/single; married-sep; $750-7,000/head of family; $1,000-10,000/ married-joint	1 - 6%
Kentucky	FAGI	-itemized deductions (fed. law) *or* -$650/all taxpayers (increases annually to $1,700 at 2000; indexed thereafter)	$20 tax credit per exemption	*5 Brackets* $3,000 - $8,000	2 - 6%
Louisiana	FAGI	-$4,500/single, married-sep.; $9,000/married-joint *plus* $1,000 for dependent	Combined with deductions	*3 Brackets* $10,000-50,000/ single, married-sep; $5,000-25,000/ married-joint	2 - 6%
Mississippi	Income determined by state law	-itemized deductions (fed. law) *or* -$2,300/single; $1,700/ married-sep; $3,400/married- joint	$6,000/single; $9,500/married-joint *plus* $1,500 per dependent	*3 Brackets* $5,000 - $10,000	3 - 5%
North Carolina	FTI	-itemized deductions (fed. law) *or* -$3,000/single; $5,000/ married-joint	$2,000 per exemption	*3 Brackets* $10,625-50,000/ married-sep; $12,750-60,000/ single; $17,000- 80,000/head of household; $21,250-100,000/married-joint, surv. spouses	6 -7.75%
South Carolina	FTI	-itemized deduction (fed. law) *or* -federal standard deduction	federal personal exemption amounts	*6 Brackets* $2,250-$11,250 (for 1997, $2,280-11,400)	2.5 - 7%
Virginia	FAGI	-itemized deductions (fed. law) *or* -$3,000/single; $5,000/married-joint	$800 per exemption	*4 Brackets* $3,000-$17,000	2 - 5.75%
West Virginia	FAGI	None	$2,000/single *or* $4,000/ married-joint *plus* $2,000 per dependent	*5 Brackets* $5,000-30,000/ married-sep.; $10,000-60,000/all others	3 - 6.5%

Source: ACIR, *Significant Features of Fiscal Federalism, Volume 1,* 1996; CCH, Inc., *State Tax* Guide, 1997.

Figure 5

Individual Income Tax
As A Percentage of Total State Tax Revenue
For the Tax Year 1995



Overview

Throughout the United States, a diversity of practices exist regarding state individual income taxation. The dominant practice is to couple the state income tax to the federal tax. Individual states which couple to the federal tax use three basic starting points to calculate individual income taxes. Twenty-seven states start with FAGI, seven states start with FTI, and three start with federal tax liability. Four states base their calculations on specifications defined in those states' legislation. Two states tax only dividends and interest. The remaining seven states do not impose an individual income tax. The individual income tax requirements vary widely among the Southeastern states. Most states, including Georgia, use FAGI or FTI as the starting point for tax calculations. Exceptions in the Southeast are:

(1) Arkansas and Mississippi, which bases its calculations on state legislation;

(2) Tennessee, which taxes only dividends and interest; and

(3) Florida, which imposes no individual income tax.

Tax Rates and Brackets

Across the country, states utilize up to 10 taxable income brackets, with tax rates ranging from .04 to 12 percent of taxable income. As noted earlier, a large number of states use a single tax rate for all taxpayers. Tennessee, which taxes only dividends and interest income, is the only Southeastern state to use a one-rate structure. For the other states in the Southeast, the number of brackets ranges from three to six, with tax rates ranging from 1 to 7.75 percent. Georgia's six tax brackets range from 1 to 6 percent. No other Southeastern state comparable to Georgia has a 1 percent tax bracket and few in the nation have brackets that low. As Table 15 shows, most states in the Southeast have tax rates as high as 6 percent. Three states, North Carolina, South Carolina, and West Virginia, have higher tax rates, with the highest being 7.75 percent in North Carolina.

When the threshold amounts of the brackets are considered, differences among the states become more pronounced. Georgia's brackets span lower income amounts than the comparable Southeastern states. In Georgia, the highest tax bracket begins with single individuals who have more than $7,000 of taxable income. Those states with higher rates apply those rates to higher income ranges than Georgia's highest bracket. For example, North Carolina's 7 percent bracket applies to joint filers with taxable income over $21,250; the 7.75 percent bracket applies to joint filers with taxable income over $100,000. While these rates seem high compared to Georgia's, other states outside the Southeast have rates as high as 12 percent.

Four Southeastern states which have federal income as their tax basis use three tax brackets, Alabama, Louisiana, Mississippi, and North Carolina. The taxable amounts covered within each brackets vary from $1,000 to over $50,000. These income ranges seem large compared to Georgia's ranges of $1,000 and $2,000 but numerous states throughout the U.S. brackets covering even larger income ranges.

Personal Exemptions and Standard Deductions

Personal exemption and standards deduction amounts vary significantly among the states. Georgia's exemption and standard deduction amounts are on par with other states in the Southeast. Louisiana has combined exemption and standard deduction amounts of $9,000 for joint filers and $4,500 for singles plus $1,000 for each dependent. These amounts are almost twice those of Georgia and are higher than most states in the nation. Other states within the region have amounts that are more comparable to the average in the United States.

Percent of Total Revenue Coming from Individual Income Taxes

Another way to gauge how important the individual income tax is to a state's economy is to look at the proportion of total revenues obtained from that tax. For the tax year 1995, the national average for all states was 13.9 percent; the average in the Southeast was 11.7 percent. When looking at these averages, one must consider that some states do not have individual income taxes or limit the tax to only capital income. For the same years, the average for the Southeast excluding Tennessee and Florida was 15.9 percent.

Virginia and North Carolina received the highest portion of total revenues from individual income taxes of all Southeastern states in 1995. Virginia's per capita income is the highest in the Southeast and the state has lower than average personal exemption and standard deduction amounts. Therefore, that state's taxable base is higher than other states in the region, which yields higher taxes per capita than other states in the region. A partial explanation for the high collection of taxes in North Carolina are their relatively higher rates. While all other states have their lower rates in the range of 1 percent to 3 percent, North Carolina's lowest rate is 6 percent.

Georgia received almost 18.9 percent of its total revenues from individual income taxes in 1995. Two factors explain the high percentage of revenues obtained from individual income taxes. First, Georgia reaches the threshold of its highest taxable income at lower income levels than most states in the region. Second, Georgia's per capita income is higher than the average for the Southeastern states, providing a larger taxable base than most of the other Southeastern states have.

Louisiana and Mississippi, the states having the lower percentages of total revenue obtained from individual income taxes, have large exemption and standard deduction amounts. Additionally, as noted earlier, Mississippi is extremely generous with deductions for retirees. These factors, combined with lower than average per capita incomes provide a much smaller taxable base resulting in lower individual income tax collections.

VI. ISSUES CONCERNING THE STATES

A number of important individual income tax issues have arisen for all states over the past decade. The recent recession demonstrated the problems of heavy reliance on taxes that negatively respond to economic downturns. In 1990 and 1991, a number of states faced revenue shortfalls which were made up in a variety of ways.[32] While some of the fiscal pressure associated with the recession has been relieved, the experience has led many states to look more closely at their revenue structures.[33]

Many states have also experienced aberrations in their revenue from the individual income tax due to changes in the federal income tax structure. In 1986, the federal government expanded its taxable income base, lowered marginal tax rates, and eliminated the deduction for the sales tax. States that were coupled to the federal system by using FAGI or FTI saw a windfall gain from the expanded tax base. At the same time, however, the reduction in marginal tax rates and the elimination of sales tax deductibility increased the "price" of state and local public goods. These

[32] For more information on these pressures see Dye and McGuire (1991) and Snell (1993).

[33] For more information, see Gold (1991).

federal changes put pressure on states to analyze the cost of using each type of tax. For states that continue to couple to the federal tax structure, state individual income tax revenue will respond to changes at the federal level. The value of the increase in simplicity associated with coupling is called into question as the magnitude of federal tax changes increases, thereby reducing local sovereignty.

Tax credits provide an increasingly popular means to alter the effective tax paid by certain income groups, for certain activities, for people with various disabilities, and for the elderly. The most recent changes at the federal level show an increase in the use of the income tax as a redistributive mechanism. It has long been held that the federal government should be responsible for income redistribution, not state and local governments.[34] When states couple to federal measures, they, in effect, engage in redistribution. Finally, there is a general issue regarding the progressivity of the individual income tax. The extent to which the individual income tax should be used to equalize incomes is a big policy question.

Trends Throughout the Southeast

Over the last ten years, many changes in individual income tax regulations occurred in the Southeast. In general, the states have:

(1) Reduced the number of brackets,

(2) Allowed for generous deductions for retirement income,

(3) More closely aligned their requirements with federal regulations, where the state's underlying tax basis is federal legislation,

(4) Eliminated indexing of rates, and

[34] Musgrave, 1959.

(5) Passed legislation specifically designed to tax income of non-residents received within the state.

The information in Table 16 summarizes changes that states have made to their individual income tax structures in the last decade and a half.

Topics addressed by Southeastern states for 1996 and 1997 primarily focus on tax credits for development in certain areas, for different types of activities, and to allow relief to lower-income individuals or families with children.

TABLE 16
MAJOR STATE INDIVIDUAL INCOME TAX CHANGES
FOR TAX YEARS 1982 THROUGH 1996, WITH SELECTED INFORMATION FOR 1997, 1998

STATE	YEAR OF CHANGE	DESCRIPTION OF CHANGE
Mississippi	1982	Increased personal income tax rates.
South Carolina	1982	Increased personal income tax rates and eliminated indexing of brackets.
Louisiana	1983	Decreased the personal exemption from $6,000 to $4,500 for single taxpayers and from $12,000 to $9,000 for married taxpayers.
South Carolina	1983	Increased personal income tax rates.
West Virginia	1983	Increased personal income rates and temporarily imposed a surtax on personal income taxes.
Mississippi	1984	Extended or made permanent previously enacted temporary taxes.
South Carolina	1984	Decreased tax revenue by changing the tax base.
North Carolina	1985	Enacted personal income tax credit ranging from $15 to $25 and increased personal income tax credit for day care.
South Carolina	1985	Reformed personal income tax.
Tennessee	1985	Increased exemptions for dividend income tax.
West Virginia	1985	Allowed temporary 12% personal income tax surcharge.

TABLE 16
MAJOR STATE INDIVIDUAL INCOME TAX CHANGES
FOR TAX YEARS 1982 THROUGH 1996, WITH SELECTED INFORMATION FOR 1997, 1998

STATE	YEAR OF CHANGE	DESCRIPTION OF CHANGE
Louisiana	1986	Suspended certain income tax credits.
North Carolina	1987 or 1988	Reduced brackets from 5 to 2. Raised the threshold level for the lowest bracket from $2,000 to $12,750.
South Carolina	1987 or 1988	Eliminated the lowest tax bracket.
Virginia	1987 or 1988	Raised the upper limits for some of tax brackets.
West Virginia	1987 or 1988	Reduced highest brackets from 13% to 6.5%.
North Carolina	1989	Reformed personal income tax to conform to Federal taxable income.
South Carolina	1989	Reduced personal income tax and strengthened indexing provisions. Revised income tax treatment of state and Federal pensions.
Virginia	1989	Provided new income tax credit for middle-income groups. Provided exemption for pension recipients.
West Virginia	1989	Revised income tax treatment of state and Federal pensions.
Arkansas	1991	Reduced liability for low-income filers by increasing income level, depending on filing status, at which liability is incurred. Eliminated 60% capital gains exclusion and imposed 6% maximum tax rate.
Georgia	1991	Enacted tax credit for low-income persons.
North Carolina	1991	Increased tax rate for highest income bracket.
South Carolina	1991	Revised retirement deduction requirements. Conformed to Federal tax code. Limited special tax treatment of capital gains earned between January and June 1987.
Virginia	1991	Conformed to Federal code regarding itemized deductions for upper income taxpayers.
Georgia	1992	Modified treatment of capital gains on sale of personal residence.
Kentucky	1992	Conformed to Federal tax treatment of high-income taxpayers.

TABLE 16
MAJOR STATE INDIVIDUAL INCOME TAX CHANGES
FOR TAX YEARS 1982 THROUGH 1996, WITH SELECTED INFORMATION FOR 1997, 1998

STATE	YEAR OF CHANGE	DESCRIPTION OF CHANGE
Louisiana	1992	Continued temporary suspension of $25 credit per child for educational expenses; provided credit for losses for video productions made in-state (effect on revenue is expected to begin in 1994).
Mississippi	1992	Eliminated deductibility of prior year's state income tax from state income tax liability.
South Carolina	1992	Delayed capital gains rate reduction. Adopted Federal withholding statutes or nonresident shareholders of subchapter S corporations.
West Virginia	1992	Modified withholding for distributions to nonresidents by partnerships, S corporations, estates, trusts, etc.
Georgia	1993	Conformed to Federal Internal Revenue Code.
South Carolina	1993	Delayed increase in capital gains exclusion.
West Virginia	1993	Imposed tax on lottery winnings; required withholding on prizes of $5,000 or more. Personal income tax terms conformed to Federal tax meaning.
Georgia	1994	Imposed tax on lottery winnings; required withholding on prizes of $5,000 or more. Increased exemptions for dependents and retirement income. Raised exemption from withholding from wages of dependents. Defined "periodic payment"; amended withholding requirements. Enacted Business Expansion Support Act of 1994, which provides tax credits for employers for increasing workforce, investments, retraining efforts, and providing child care, with restrictions, based on the economic situation in the area in which the activity occurs. Updated references to Federal Internal Revenue Code.
Kentucky	1994	Allowed Revenue Cabinet to require electronic funds transfer of withholding for $25,000 or more per month. Allowed innocent spouse to qualify for relief from state income tax liability. Prioritized the credits allowed against personal income tax. Enacted Limited Liability Company Act, following Federal guidelines. Updated references to federal Internal Revenue Code.

TABLE 16
MAJOR STATE INDIVIDUAL INCOME TAX CHANGES
FOR TAX YEARS 1982 THROUGH 1996, WITH SELECTED INFORMATION FOR 1997, 1998

STATE	YEAR OF CHANGE	DESCRIPTION OF CHANGE
Louisiana	1994	Allowed disabled persons deduction for home improvements. Enacted credit for certain post-secondary educational expenses for law enforcement officers. Continued suspension of education tax credit for children attending kindergarten through 12th grade. Disallowed credit for local inventory tax paid on certain motor vehicles. Extended capital companies tax credit program. Enacted credit for alcohol and substance abuse programs. Enacted credit for employment of certain drug offenders.
Mississippi	1994	Exempted retirement income from Federal, state, and private retirement systems from tax. Adopted tax credit for port users (to be repealed after 12-31-98).
North Carolina	1994	Extended and increased credits for solar energy equipment installed by individuals or partnerships. Authorized pass-through of income tax credits by partnerships. Amended credit for use of North Carolina ports. Extended time for credit for certain real property donations (marshlands). Extended time for which credit allowed for construction of fuel ethanol distillery. Updated references to federal Internal Revenue Code. Allowed credit (until 12-31-98) for qualified donations of North Carolina realty for land conservation purposes subject to limitations.
South Carolina	1994	Enacted Limited Liability Company Act, following Federal guidelines. Allowed supplemental deductions for children under the age of six. Provided credits for employers hiring former employees of closed military installation. Delayed increase in deduction for net capital gain. Provided for withholdings on certain types of income. Defined rules for eligibility for jobs tax credit. Clarified existing regulations regarding credits, exclusions, withholdings, and due dates.
Tennessee	1994	Allowed credit to S corporation shareholders for taxes paid to other states. Enacted Limited Liability Company Act, following federal guidelines.

TABLE 16
MAJOR STATE INDIVIDUAL INCOME TAX CHANGES
FOR TAX YEARS 1982 THROUGH 1996, WITH SELECTED INFORMATION FOR 1997, 1998

STATE	YEAR OF CHANGE	DESCRIPTION OF CHANGE
Virginia	1994	Provided for credit for taxes paid to other states for gains on sales of principal residences. Extended retroactively deduction allowed persons aged 62 or older. Delayed low-income housing credit until 1-1-96. Enacted major business facility job tax credit. Expanded credit option for clean-fuel vehicles. Reduced FAGI for amounts of self-employment tax added to FAGI in prior tax years.
Arkansas	1995	Adopted federal Internal Revenue Code sections regarding inclusion in gross income of moving expense reimbursements; exclusion from gross income of meals or lodging furnished for an employer's convenience; exclusion from gross income of certain cost-sharing payments; exclusion from gross income of certain foster care payments; exclusion from income of certain fringe benefits for purposes of computing income tax liability; medical and dental expense deductions; interest deductions; charitable contributions' deductions; moving expense deductions; limit on passive activity losses and credits; limit on itemized deductions. Allows credit for adoption expenses. Revised definition of adjusted gross income.
Georgia	1995	Extended 3-factor apportionment factor to service companies. Established individual income tax credit for certain physicians practicing in defined rural areas. Established new tax credit for employers hiring AFDC recipients. Updated references to federal Internal Revenue Code.
Mississippi	1995	Allowed deduction of amounts contributed to retirement plans if it meets requirements of qualified plans. Dependent care tax credit expanded to provide child care to children less than age 18 or for dependent adult relatives.
North Carolina	1995	Include amount of federal estate tax attributable to an item of income from a decedent and deducted from gross income under IRC Sec. 691© Allows tax credits for children if FAGI is not above specified threshold amount; poultry composting facility (until 1-1-98); tax credit for distributing North Carolina wine (through 1995). Issued new rules for taxation of nonresident athletes. Updated rules regarding conformance with federal Internal Revenue Code.

TABLE 16
MAJOR STATE INDIVIDUAL INCOME TAX CHANGES
FOR TAX YEARS 1982 THROUGH 1996, WITH SELECTED INFORMATION FOR 1997, 1998

STATE	YEAR OF CHANGE	DESCRIPTION OF CHANGE
South Carolina	1995	Allowed deduction of subsistence allowance for law enforcement officers /firefighters. Extended applicability of jobs tax credit to different types of taxpayers. Amended regulations to allow two-wage-earner credit on nonresident return Three-factor apportionment formula replaced by four-factor formula--double-weighted on sales, single-weighted on property and payroll. Allowed employer child care credit Provided tax credits for enterprise zone activities. Granted credit for hiring AFDC recipients. Tax credit allowed for hiring federal workers terminated by federal base closings. Updated rules regarding conformance with federal Internal Revenue Code.
Tennessee	1995	New rules regarding trustees of charitable remainder trusts and the reporting of taxable income.
Virginia	1995	Reduced FAGI by amount of "qualified" or "basic" research expenses eligible for deduction but not deducted due to Internal Revenue Code provisions. Allowed tax credits for businesses established in enterprise zones.
West Virginia	1995	Allowed deduction from FAGI contributions to medical savings accounts established by individuals subject to limitations.
Alabama	1996	Allowed deduction for amount of premium paid under qualifying insurance contracts for qualified long-term care coverage.
Arkansas	1996	Required 10% surcharge on tax liability of residents in school districts that do not levy the base property tax millage rate.
Kentucky	1996	Revised requirements for filing estimated tax returns.
Louisiana	1996	Granted tax relief for military personnel who served in Bosnia in accordance with federal requirements. Provided tax credits for employers who alcohol/substance abuse programs for employees.

TABLE 16
MAJOR STATE INDIVIDUAL INCOME TAX CHANGES
FOR TAX YEARS 1982 THROUGH 1996, WITH SELECTED INFORMATION FOR 1997, 1998

STATE	YEAR OF CHANGE	DESCRIPTION OF CHANGE
North Carolina	1996	Allowed deduction of up to $35,000 of severance wages paid to taxpayers due to permanent closing of manufacturing or processing facility. Allowed federal retirees a personal income tax credit for taxes paid during 1985-1988 (repealed effective 1-1-03). Allowed credit to owners of pass-through entities subject to limitations. Updated rules regarding conformance with federal Internal Revenue Code. Until 1999, allowed credit for qualified business investments.
Virginia	1996	Allowed reduction of FAGI by income derived from retirement plans and deductible for FAGI purposes, but taxed in another state. Allowed deduction of military pay and allowances for service in any part of former Yugoslavia and Bosnia. Extended tax credits allowed for rent reductions to elderly or disabled tenants.
West Virginia	1996	Added to FAGI amounts withdrawn from medical savings accounts for purposes other than medical payments. Allowed taxpayers deduction based on low income exclusion.
Alabama	1997	Afforded same tax deferred treatment to deferred compensation plans as allowed by federal Internal Revenue Code.
Kentucky	1997	Increased standard deduction from $650 each year until the year 2000, after which it will be indexed for inflation.
Louisiana	1997	Required same tax rates on estates and trusts as on individuals. Allowed tax credits for physically or mentally handicapped dependents.
North Carolina	1997	Allowed individuals to have withholdings from payments of unemployment compensation.
Virginia	1997	Allowed credit for rehabilitation of certified historic structures against taxes based on percentage of expenses.
West Virginia	1997	Allowed tax credits for expenditures to protect the environment for purchases of qualified agricultural equipment.
Kentucky	1998	Include in gross income all previously untaxed distributions from certain retirement plans.

Source: CCH,. *State Tax Guide,* 1992-1997; *Significant Features of Fiscal Federalism,* Volume 1, 1983-1994.

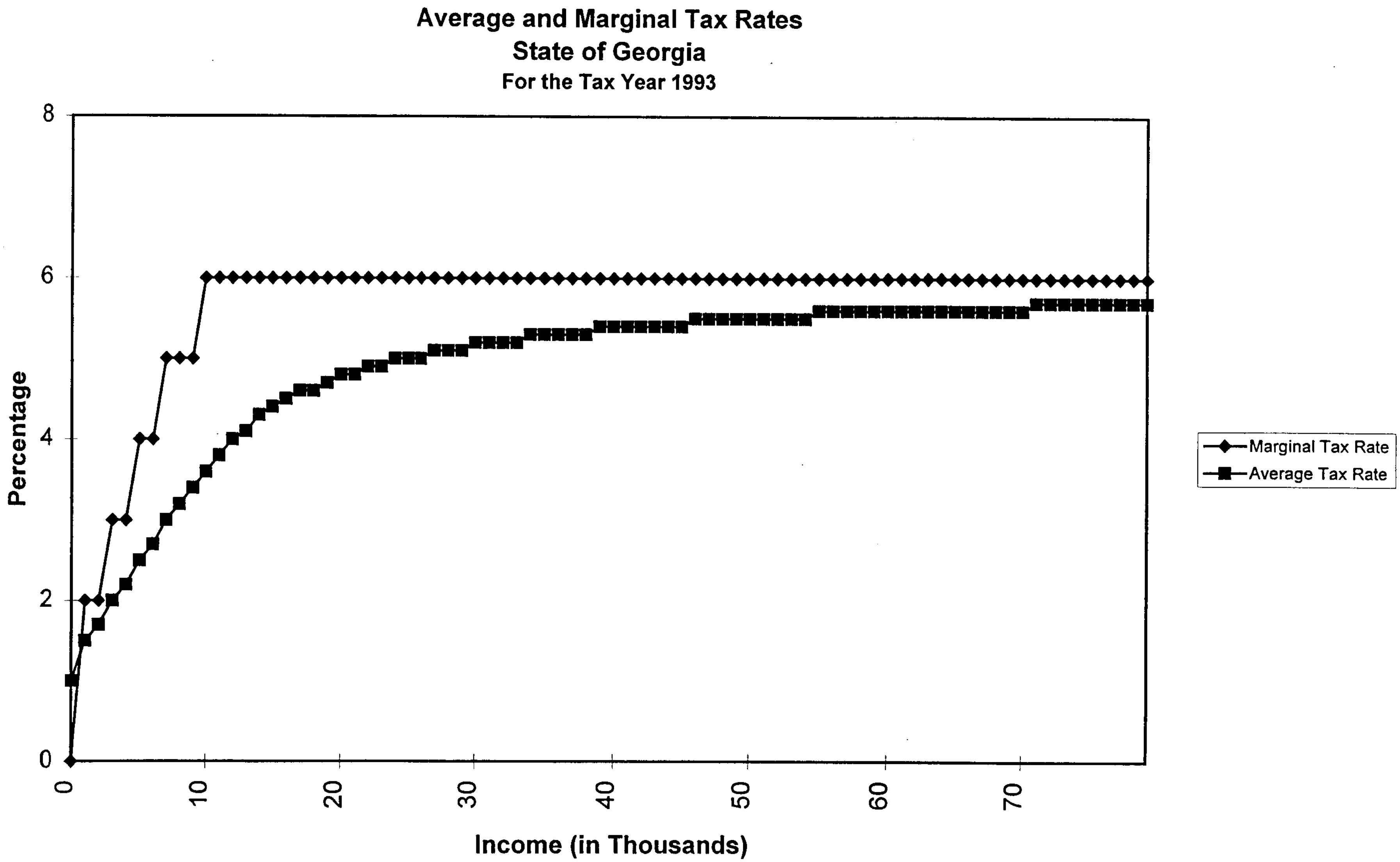
VII. GENERAL ISSUES FOR GEORGIA

The structure of the individual income tax in Georgia can be summarized as follows. The tax structure is relatively "clean," with few adjustments and credits. The number of brackets is similar to that of other states. The state's individual income tax rate structure is in line with that of other Southeastern states, although the rates are a bit lower than those of the nation as a whole. The tax brackets are relatively narrow. The top taxable income bracket is lower than that of most other states, including those in the Southeast. The income tax structure does not provide for indexation of rates or brackets. The tax treatment afforded the elderly with retirement income is more generous than that provided by most states for non-state pensioned retirees. Finally, the tax is a very important revenue source for the state and its growth has slowed in recent years relative to the growth in the 1980's.

If all of these observations of Georgia's individual income tax are combined, there are five policy issues. First, the individual income tax is becoming a flat rate tax due to the low income level at which the tax rate is reached (see Figure 6) and the lack of indexation. As taxpayers' incomes grow with inflation, they experience bracket creep. In Georgia, a larger and larger percentage of the population faces a 6 percent marginal tax rate. Positive aspects to a flat tax include increased taxpayer compliance and lower administrative costs that would encourage the continued use of the current system. However, distributional issues may warrant more progressivity than a flat rate system allows. This policy question requires study and debate by Georgia's policy makers.

Second, while the system is not overly complex, there are ways to reduce its complexity. For example, if the state moved to FTI as its taxable income base, it would eliminate the additional calculations of Georgia exemptions and deductions. A further move would be to use federal tax

Figure 6



Average and Marginal Tax Rates
State of Georgia
For the Tax Year 1993
8
6
4
2
0
Percentage
0
10
20
30
40
50
60
70
Income (in Thousands)
Marginal Tax Rate
Average Tax Rate

liability as the tax base, thus removing almost all of the current calculations from the Georgia individual income tax form.[35] While both of these alternatives might lead to higher taxpayer compliance and lower administrative costs, they suffer from the problem of moving more of the tax policy decisions regarding tax bases and rates from the state of Georgia to the federal government.

A third issue specific to Georgia is the cost of the retirement income deduction. While other states allow such an exclusion, Georgia offers one of the most generous retirement income deductions. The state needs to grapple with the fact that an increasing proportion of income in the state will be derived from retirement income. As the number of retirees grows, the income exempted from individual income taxation will continue to grow; it will erode the individual income tax base. One consideration for change is to increase the standard deduction and personal exemption for all individuals, which would protect the poor elderly as well as the poor population in general. A similar argument exists for the exclusion of the federally taxable portion of social security income, which Georgia has adopted.

The fourth policy issue, the growth and importance of the individual income tax, presents a cause for concern. As discussed, the state of Georgia relies heavily on the income tax, but the elasticity of the tax has decreased somewhat over the last decade. Much of the natural growth in the system has been "used-up" since the majority of individuals are in the highest tax bracket and the state has afforded retirement income increased exemptions. While the entire tax system should be examined, policy makers should first address two specific questions about the income tax. First, is it time to make the income tax a more stable source so that it grows more predictably with income,

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[35] Moving to a tax base of federal tax liability might require a change in the Georgia Constitution since the Constitution prohibits the delegation of powers of taxation.

or second, is it time to increase its elasticity. In the first case, a flat-rate tax would result in a more stable and predictable revenue source. If policymakers wish to increase the elasticity of the tax, additional brackets might be added or existing brackets might be widened.

Among major policy issues, the last is the issue of the indexation of the individual income tax system. Currently, neither the brackets, nor exemptions, nor standard deduction amounts are indexed for inflation. Due to the lack of indexation, more individuals are brought into the taxable income net each year. From a policy perspective, the state determines each year how far down the individual income tax should reach. By not indexing, this level gets lower each year. The state has made some adjustments to increase exemptions and deductions, but these adjustments are not done regularly. An annual system of indexing would decrease the political and time cost of adopting reforms every few years. It would also serve to protect those individuals with relatively low incomes.

In addition to these large issues, there are two smaller points. First, the state allows itemizing individuals to deduct state income tax paid to Georgia within the calendar year, effectively lowering the tax rate for individuals that itemize, thus reducing potential state revenues and decreasing horizontal equity. Second, the state individual income tax system exempts the unearned income of dependents, again leading to revenue losses for the state reducing the horizontal and vertical equity of the system.

To address this list of issues in Georgia, various changes to the tax structure should be examined for their impacts on equity, revenue yield, elasticity, and burden relative to Georgia's neighbors. The next section presents such analyses for a variety of policy options faced by the state of Georgia.

VIII. POLICY OPTIONS

The information presented in this study points to a number of potential changes to the individual income tax in Georgia that would address the problems with elasticity, equity, revenue yield, and overall tax burden. This section presents the anticipated results of a number of potential options. The burden and revenue estimates of these proposals were developed using the Georgia Microsimulation Model. This model is explained in more detail in Appendix A. All of these options were considered based on various merits, as noted in the discussion below.

Option #1: Increase the standard deduction of all filers to the 1996 federal standard deduction level. This option would raise the current Georgia standard deductions to the federal levels as follows:

	Current Law	Proposed Law
Joint Filers	$3,000	$6,700
Singles	$2,300	$4,000
Head of Household	$2,300	$5,900
Married/Separately	$1,500	$3,550

Option #2: Increase the personal exemption for all filers, taxpayers, spouses, and dependents to the 1996 federal levels. This option would raise the current Georgia personal exemptions as follows:

	Current Law	Proposed Law
Personal Exemption (dependents)	$2,500	$2,550
Personal Exemption (others)	$1,500	$2,550

Option #3: Increase both the personal exemption and standard deductions to the 1996 federal levels. This option combines the first two and generates a relatively high threshold for taxation in the state of Georgia. As discussed below, this option may effectively take a number of people off the tax rolls.

Option #4: Use current Georgia law, adjusted gross income with federal exemptions and deductions, and a 6 percent flat rate for all taxpayers.

Option #5: Eliminate all retirement income exemptions.

Option #6: Add a 7 percent tax bracket at $8,250 for singles, $13,000 for married filing jointly, and $6,550 for married filing separately filers. All other aspects of the code would remain as in the current Georgia tax law.

These options illustrate the effect certain changes would have on Georgia's tax structure, distribution of tax burden, revenue, and elasticity. These impacts are discussed below.

Option #1: The data in Table 17 show the result of increasing the standard deduction level of all filers to the 1996 federal standard deduction level. The higher standard deduction amount results in a 5.0 percent decrease in personal income tax receipts and lower tax burdens for all filers. The largest benefit goes to those in the lower income groups ($5,000 - $10,000), resulting in a somewhat more progressive burden than that of the current system. This change slows the decrease in elasticity that we expect from an unindexed system as it effectively stretches out the current brackets. Also, if individuals are not eligible for the food credit or do not file for the credit, this increased deduction amount will decrease the number of individuals filing taxes, leading to administrative savings due to a reduction of the paperwork and audit processing. Finally, as many states have coupled their standard deductions to the federal levels, this change would move Georgia closer to what other states do with respect to their standard deduction amounts.

Option #2: The results of an increased personal exemption, as illustrated in Table 17, show effects similar to the standard deduction increase. This change would lead to a 4.5 percent revenue loss and a decrease in the tax burden for all tax filers. The benefit is spread throughout the income distribution, as those with standard deductions as well as itemizers benefit from this change. This change would also yield a potential administrative saving if the increased personal exemption kept some individuals from filing. Since the current dependent exemption level is $2,500, this change would also make it easier for the taxpayer to fill out their tax forms, and reduce the number of errors in calculations. As with the standard deduction increase, this change would increase the elasticity of the tax over time. This change would also move Georgia's personal exemption amounts closer to the average amounts granted in other states.

TABLE 17
TAXES PAID AS IN A PERCENTAGE OF FEDERAL GROSS INCOME
CURRENT LAW, OPTIONS 1,2,3,4,5,6
1996 LAW, 1993 LEVELS
(All numbers in thousands except percents)

Original Federal AGI Class		Federal AGI	Current Law-Taxes Paid		Option 1-Taxes Paid		Option 2-Taxes Paid		Option 3-Taxes Paid	
			Amount	As % of Fed AGI	Amount	As % of Fed AGI	Amount	As % of Fed AGI	Amount	As % of Fed AGI
Under	$1,000	$25,378	$20	0.06	$15	0.05	$17	0.06	$12	0.05
$1,000	$5,000	790,340	473	0.06	250	0.03	460	0.05	100	0.02
$5,0 00	$10,000	2,445,800	21,402	0.87	8,401	0.34	14,466	2.59	4,839	0.20
$10,000	$15,000	3,976,700	75,347	1.89	47,730	1.20	62,192	1.56	37,391	0.94
$15,000	$25,000	9,702,700	283,140	2.91	230,300	2.37	254,990	2.62	203,770	2.10
$25,000	$35,000	9,540,000	334,310	3.50	303,470	3.18	311,230	3.26	280,620	2.94
$35,000	$50,000	14,070,000	533,780	3.80	510,000	3.62	505,390	3.59	481,750	3.42
$50,000	$75,000	16,691,000	673,210	4.03	664,490	3.98	647,110	3.88	638,390	3.82
$75,000	$100,000	8,329,200	353,640	4.24	352,730	4.23	344,060	4.13	343,150	4.12
Over	$100,000	18,750,000	893,990	4.77	893,670	4.76	884,880	4.72	884,560	4.71
	Total:	$84,320,000	$3,169,300	3.75	$3,010,800	5.0	$3,024,410	3.58	$2,874,500	3.41

Source: GSU simulations based on individual income tax data from the Georgia Department of Revenue, 1993 levels, 1996 law.

TABLE 17 (cont.)
TAXES PAID AS IN A PERCENTAGE OF FEDERAL GROSS INCOME
CURRENT LAW, OPTIONS 1,2,3,4,5,6

(All numbers in thousands except percents)

Original Federal AGI Class		Federal AGI	Current Law-Taxes Paid		Option 4-Taxes Paid		Option 5-Taxes Paid		Option 6-Taxes Paid	
			Amount	As % of Fed AGI	Amount	As % of Fed AGI	Amount	As % of Fed AGI	Amount	As % of Fed AGI
Under	$1,000	$25,379	$20	0.06	$22	0.01	$21	0.08	20	0.06
$1,000	$5,000	790,340	473	0.06	10	0.01	473	0.06	473	0.06
$5,000	$10,000	2,445,800	21,402	0.87	16,944	0.60	21,403	0.88	21,404	0.88
$10,000	$15,000	3,976,700	75,347	1.89	86,211	2.12	75,975	1.91	76,489	1.92
$15,000	$25,000	9,702,700	283,140	2.91	317,260	3.23	288,050	2.97	301,610	3.11
$25,000	$35,000	9,540,000	334,310	3.50	372,450	3.91	342,880	3.59	367,990	3.86
$35,000	$50,000	14,070,000	533,780	3.80	593,850	4.23	545,250	3.88	597,140	4.24
$50,000	$75,000	16,691,000	673,210	4.03	741,180	4.40	684,060	4.10	762,710	4.57
$75,000	$100,000	8,829,200	353,640	4.24	380,811	4.63	357,830	4.30	404,350	4.85
Over	$100,000	18,952,100	893,990	4.77	920,320	4.82	899,900	4.80	1,035,100	5.52
	Total:	$84,320,000	$3,169,300	3.75	$3,429,000	4.07	$3,215,800	3.81	$3,567,300	4.23

Source: GSU simulations based on individual income tax data from the Georgia Department of Revenue, under 1996 law.

Option #3: Combining the first two options would truly be a tax savings for a number of families. For example, a family of four would currently enter the tax system at $11,000 of income. Under this proposal, they would enter the system at $16,550. Effects are similar for other taxpayers. Two notable results are: (1) for all taxpayers, there is a significant reduction in income tax liability, as is shown in Table 17, and (2) if the taxpayer is not able to or does not choose to file for the current food credit, the administrative burden of their return is eliminated. This option would bring Georgia to the upper-middle tier of exemption/deduction amounts. This change would cost the state approximately 9.3 percent in state individual income tax revenues.

Option #4: This policy option is aimed at simplification of the system, with some progressivity introduced through the use of larger standard deductions and personal exemptions. A shift from the present graduated rate structure to a flat rate of 6 percent on a base which uses the federal deduction and exemption levels would result in a 8.2 percent increase in personal income tax revenues (see Table 17). Using this flat rate, the system retains some progressivity (due to the standard deductions), but it is obviously less progressive than the current structure. All except the lowest income groups ($1,000 - $5,000) would experience slightly higher effective income tax rates. Increases would be largest for the middle-income groups.

This change would slightly decrease the current elasticity of the income tax, but would simplify the system. The number of filers could decrease due to the increased standard deduction and personal exemption amounts. The flat rate may reduce the compliance costs due to its relatively simple nature. A change to a flat-rate structure using federal taxable income would be novel compared to recent changes in state income tax policy nationwide.

Option #5: This option would eliminate all retirement income exemptions for purposes of defining Georgia taxable income. Such a move goes against current trends. In many cases, states are looking for ways to give the elderly more breaks with respect to many taxes. However, these exemptions are expensive and will continue to grow in cost as Georgia's population ages.

Removing the $12,000 retirement income deduction would raise revenues by approximately 1.5 percent. This change would increase the tax burdens for most income groups, except the very lowest (Table 17). The pattern of change in tax burdens reflects the fact that the majority of taxpayers claiming an exemption for retirement income are in the middle-income classes. This change would also increase the elasticity of the tax over time, relative to the present system, because retirement income is growing relatively rapidly. Exempting this income has lowered the actual and potential growth of the income tax over time.

Option #6: This option of adding an additional rate would not only increase the progressivity and elasticity of the system, but it would increase the natural growth of the tax. Those taxpayers who are solidly in the 6 percent bracket would see some of their income taxed at 7 percent under this option. As shown in Table 17, this change would yield a 12.6 percent increase in income tax revenue. The tax burden would increase for all but the lowest income groups, with the burden increasing as incomes become higher. Few states have recently increased their top marginal tax rates, primarily because it is such an unpopular move (North Carolina is a recent exception).

IX. CONCLUSION

This report presented an overview of the issues in the design of an individual income tax system, and concentrated on the current status of Georgia's individual income tax. Relative to other states in the Southeast, Georgia's standard deductions are slightly low to average. Relative to the rest of the U.S., the exemptions levels for non-dependents are low. While the number of tax brackets in Georgia is on par with the Southeast and the U.S., the size of the brackets is very narrow. This structure, coupled with a lack of indexation, has taken the natural growth out of the income tax in Georgia. These two factors have effectively pushed a large percentage of the taxpayers into the highest tax bracket. Georgia's retirement income exemption is relatively high, which is one reason for the decline in the growth of income tax revenue in Georgia.

While Georgia's individual income tax is relatively simple and "clean", policy makers have a number of issues to consider: indexation, progressivity of the system, growth of income tax revenue, coupling to the federal system, the retirement income exclusion, and the relatively low personal exemptions and standard deductions. A number of policy options for dealing with these issues were analyzed, and these showed some trade-offs among equity, revenue yield and elasticity.

APPENDIX A

INDIVIDUAL INCOME TAX MODEL

This appendix provides technical information regarding the Georgia micro-simulation model, data, and output. It also contains examples of the revenue and distributional consequences of changes to the Georgia income tax code.

The Georgia Individual Income Tax Simulation Model is comprised of a sample of Georgia individual tax returns, a tax calculator computer program written in the programming language, C++, and an output program which creates tabulations of taxable income, tax liability, tax burden, deductions, exemptions, and credits for Georgia income taxpayers. In 1993, there were 2.85 million individual income tax returns filed in the state of Georgia. The Department of Revenue creates a computer file containing most of the information provided on these returns including Federal Adjusted Gross Income (AGI), Georgia AGI, total exemptions, total itemized deductions, credits, and total Georgia tax liability. This computerized data base, the Georgia Master File, contains all of the available information on Georgia's tax filers. Although Georgia income tax filers with AGI greater than $40,000 must submit a copy of their federal itemized deductions with their Georgia return, the detailed information is not computerized by the Department of Revenue.

Since it is very difficult to process 2.85 million returns for any type of analysis, a 2 percent random sample of tax returns was taken from the Master File. This random sample resulted in a file of 56,277 returns. When the sample is weighted by the appropriate factor, the sample data file provides accurate information regarding all of the variables on the file.[36]

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[36] The weighing factor is the inverse of the selection percentage: weight = (1/(.02)) = 50.

Table 1A provides summary statistics of the master file and the sample. As shown in Table 1A, the tax liability in the Master File is $3.34 billion for 1993 and the tax liability in the sample data set is $3.19 billion--a difference of 4.2 percent. Table 2A shows data totals and percentages by filing status of the number of returns and tax liability. Table 3A presents details of those categories by taxable income group. Distributionally, the sample provides an accurate representation of taxable income, deductions, exemptions, and tax liability for the total Master file. The result is that we have a sample of Georgia tax returns that deviates very little from the actual totals in 1993.

The tax calculator is a computer program that literally calculates Georgia taxable income and tax liability under various definitions of the tax code. For example, if we increase the standard deduction to $5,000 for all filers, the program would calculate Georgia taxable income for every sample return using a standard deduction level of $5,000 instead of the current law's standard deduction. The program would then weight each of the sample returns and provide the total revenue due under the new law. Changes can be made to any component of the tax code, and can be made by filing status as well. Some changes would require imputations to the data because the master file does not include the information. Examples of such changes are the addition of an individual retirement account deduction for all filers, a tax credit for college-aged children and a tax credit for working mothers. These imputations would be made by adjusting the tax calculator using data that is available from other sources.

TABLE 1-A
SAMPLE AND ACTUAL RETURN DATA

	Actual 1993 Returns[1]	Sample 1993 Returns	Percent Difference
Number of Tax Returns	2,854,572	2,813,850	-1.4%
Taxable Income	$60,798,369,322	$58,135,000,000	-4.3%
Tax Liability	$3,336,850,799	$3,187,789,231	-4.4%

TABLE 2-A
SUMMARY OF SAMPLE RETURN DATA[2]
BY FILING STATUS AMOUNTS

	Number of Returns		Tax Liability	
Filing Status	Amount	Percent of Total	Amount	Percent of Total
Married Filing Jointly	1,228,850	43.7%	$2,311,300,000	72.5%
Single	1,060,300	37.7%	$614,140,000	19.3%
Head of Household	465,450	16.5%	$205,940,000	6.5%
Married Filing Separately	59,250	2.1%	$56,409,231	1.7%

[1] From summary tabulations provided by the Department Revenue.

[2] Based on sample extracted from data provided by the Department of Revenue.

TABLE 3A

SAMPLE RETURN DATA BY TAXABLE INCOME CLASS
AND FILING STATUS

Taxable Income Group	Number of Returns	Tax Liability	Taxable Income Group	Number of Returns	Tax Liability
Married Filing Jointly:			**Head of Household:**		
Less than $1,000	142,550	$102,079	Less than $1,000	86,000	$912569
$1,001 - $3,000	38,100	$1,129,944	$1,001 - $3,000	44,250	$1,347,009
$3,001 - $5,000	35,550	$2,812,700	$3,001 - $5,000	46,050	$3,720,363
$5,001 - $7,000	40,850	$6,109,340	$5,001 - $7,000	44,850	$6,676,846
$7,001 - $10,000	60,350	$14,693,961	$7,001 - $10,000	58,650	$15,332,425
$10,001 and over	911,450	$2,285,200,000	$10,001 and over	185,650	$178,770,000
Single:			**Married Filing Separately:**		
Less than $750	292,600	$158,759	Less than $500	6,350	$649
$751 - $2,250	78,500	$1,751,502	$501 - $1,500	1,950	$25,811
$2,251 - $3,750	63,350	$3,732,761	$1,501 - $2,500	1,900	$75,592
$3,751 - $5,250	53,600	$5,922,902	$2,501 - $3,500	1,900	$145,340
$5,251 - $7,000	55,350	$10,271,410	$3,501 - $5,000	2,800	$361,845
$7,000 and over	516,900	$592,300,000	$5,001 and over	44,350	$55,799,994

Source: GSU simulations based on individual income tax data from the Georgia Department of Revenue, 1993 levels, 1996 law.

The last component of the Georgia Individual Income Tax Simulation Model is an output program, which produces a table of statistics by income group for both current law and the proposed law change. This program enables a policy maker to study the output table and read the "winners and losers" of any change by income group. The statistics currently include taxable income, tax liability, total deductions, total exemptions, and total credits. This program can be easily adapted to produce other information as well. The output program is also written in C++ and then interfaced with WordPerfect. This interface allows the output to be easily reproduced in a report or reformatted for other types of presentation.

The Tax Model runs on a 486, 66 mega hertz personal computer. The data are maintained in a separate file on the same computer system. The total processing time for a tax code change is approximately 30 minutes, including the programming of the tax change, processing of the data, and production of the results in the output tables. The programming time is the most variable constraint. Very complicated tax code changes increase the programming time but add only a negligible amount of time to processing the data and producing the results.

APPENDIX B

SPECIFIC CHANGES TO THE GEORGIA INCOME TAX CODE: 1981-1994

Georgia legislative changes incorporated into the 1982 tax return included adding lump sum distributions from employee benefit plans to their Federal Adjusted Gross Income. Additionally, all individuals aged 62 and over could subtract retirement income from any sources from Federal Adjusted Gross Income, up to a maximum of $2,000.

In 1983, the standard deduction amounts were increased for all filers. These changes permitted more equity to the married individuals filing joint returns than in prior years by separating both the standard amount and the percent of Federal Adjusted Gross Income that was allowed for this category. The standard deduction feature retained the lower and upper limits used in prior years, but changed the amounts. This structure required the taxpayer to calculate the standard deduction as a percentage of their modified Federal Adjusted Gross Income. If the result was below the lower limit, the standard deduction lower limit amount became the taxpayer's standard deduction; if the amount was higher that the lower limit, the standard deduction was the lesser of the upper limit or the percentage calculated. Table 1B details the rate and limit changes.

TABLE 1B
CHANGES IN SELECTED AMOUNTS - 1983 LEGISLATION

	SINGLE/HEAD OF HOUSEHOLD			MARRIED FILING JOINT			MARRIED FILING SEPARATELY		
	Standard Amount	Percent of Fed AGI	Limit if Percent Used	Standard Amount	Percent of Fed AGI	Limit if Percent Used	Standard Amount	Percent of Fed AGI	Limit if Percent Used
Before '83 Changes	$1,300	15%	$2,000	$1,300	15%	$2,000	$650	15%	$1,000
1983	$1,500	15%	$2,300	$1,700	18%	$3,000	$850	18%	$1,500

Georgia's instructions for tax year 1983 highlighted an additional difference between federal regulations and Georgia regulations in the area of deductibility of casualty and theft losses. Federal legislation changed the federal requirements; Georgia continued to follow the 1-1-81 federal tax code. As with the changes highlighted in the previous year (See Table I), Georgia's requirements were those defined in the Internal Revenue Code in effect January 1, 1981. Changes legislated by Georgia in 1983 were:

(1) Implementation of a 25 percent income tax credits for modification of the workplace for handicapped individuals, with a maximum credit available of $750, and

(2) Elimination of the interest exclusion and changing the limit on dividend exclusion to $100/$200, based on the taxpayers filing status.

For tax year 1984, Georgia allowed a solar energy income tax credit equal to 20 percent of the cost of the solar materials, not to exceed $1,000. As Georgia was still coupled with the 1981 federal regulations, federal tax changes made in 1984 did not apply to Georgia. The most significant changes related to:

(1) Taxation of a portion of social security benefits and Tier I Railroad Retirement Benefits for federal purposes,

(2) The repeal of the federal disability income exclusion for tax years beginning after 1983,

(3) Reduction of the holding period for long-term capital gain from one year to 6 months for property acquired after June 22, 1984,

(4) Nontaxability of property transfers between spouses during marriage or related to a divorce or annulment, and

(5) The increasing of the amount of charitable deduction for taxpayers not itemizing deductions to allow up to 25 percent of $300 to be deducted.

A ruling by the Georgia Department of Revenue during 1985 allowed retirees to earn up to $1,200 a year and still claim the exclusion of Retirement Income. Administrative changes made by the Department of Revenue simplified the tax filing process for the taxpayer in tax year 1985. The Department introduced a short form for single taxpayers, Form 500EZ, a standard deduction table to aid taxpayers, and tax tables to assist the taxpayer in calculating the tax amount. Due to The Tax Reform Act of 1984, additional differences existed between Georgia and federal requirements. The two major changes at the federal level which did not apply at the state level that were highlighted in the 1985 tax return instructions were:

(1) Alimony payments could now be treated as compensation for IRA deduction limit purposes, and

(2) An increase of up to 50 percent of all charitable deductions allowed for taxpayers not itemizing deductions.

For the 1986 tax year, the deduction amount allowed for retirement income increased from $2,000 to $4,000. The other change highlighted in that year's instructions was the effect of another change in The Tax Reform Act of 1984, which allowed taxpayers in 1986 to deduct up to 100 percent of all charitable contributions if the taxpayer did not itemize. Georgia did not allow a similar deduction.

In 1987, the Georgia General Assembly updated the Georgia Income Tax Code to closely follow the Internal Revenue Code of 1986. This change eliminated the discrepancies caused by the federal tax laws of 1981, 1982, and 1984 and simplified the instructions for the taxpayer. In the new regulations, the General Assembly also changed the standard deduction amounts to the maximum limit used in prior years for each type of taxpayer (single, married-joint, married-separate).

Deductions for dependents were increased from $700 to $1,500. The child care credit was eliminated.

For the 1987 tax year, the requirement to include in Georgia Adjusted Gross Income dividends from pre-1969 earnings and profits by a tax option corporation was eliminated. Adjustment to Federal Adjusted Gross Income were reduced to 25 items, which can be classified into the following broad categories:

(1) Addition of interest on municipal and state bonds other than Georgia and subtraction of interest on U.S. government bonds and other U.S. obligations,

(2) Deduction allowed for up to $4,000 of retirement income and of amounts received from specific retirement systems,

(3) Addition of loss carry-overs for years when the taxpayer was not subject to Georgia Income Tax,

(4) Addition of lump-sum distributions from employee benefit plans and contributions to Teacher's Retirement System,

(5) Adjustment for differences between Georgia and federal law for tax years 1981 and 1986 in such areas as depreciation, individual retirement accounts, and other retirement plans,

(6) Subtraction of salaries and wages reduced from federal taxable income because of federal jobs credit, and

(7) Subtraction of state income tax refunds included in the Federal Adjusted Gross Income.

During 1988, the main difference was the elimination of the requirement to subtract state income tax refunds included in the Federal Adjusted Gross Income. This elimination was due to the change in the prior year allowing the taxpayer who itemized to take deductions for Georgia tax paid. The effect is the same as in the federal income tax return. Other differences from the 1987 requirements included adjustments to income for retirement amounts received from specific sources and income taxed at corporate level by other states because of the non-recognition of "S" corporation status.

For the 1989 tax year, a special session of the General Assembly increased the Retirement Income Exclusion for persons 62 years of age or older and permanently and totally disabled individuals to $8,000. With this change, many of the special categories of exemptions for retirement income granted in prior years was eliminated (such as income from Georgia fireman's pension funds, Georgia legislative retirement system, etc.).

The instructions for completing the 1989 tax return eliminated the requirement to add contributions to the Teacher's Retirement System to Federal Adjusted Gross Income. Three new items were included to be subtracted from Federal Adjusted Gross Income. These items are:

(1) Dependents unearned income included in parents' Federal Adjusted Gross Income,

(2) Income tax refunds from other states if included in Federal Adjusted Gross Income, and

(3) Funds, programs, or systems the income from which is exempted by federal law or treaty.

In reviewing these changes, a potential problem exists when individuals are allowed deductions of taxes paid to other states, but are not required to recognize as income any refunds from those states. For individuals moving into the state, this discrepancy should not distort the taxes the individual will pay because that state's taxes were probably not taken as deductions by the individual. However, individuals who regularly are taxed in two states could benefit by overpaying the tax due in the other state because they would receive a deduction in Georgia. The refund of overpayment would not be included in taxable income. Thus, the individual has just obtained a deduction for amounts that were not really expenditures.

Another change made in the Georgia income tax form for 1989 was to include a line for contributions to the Nongame Wildlife Conservation and Wildlife Habitat Acquisition Fund on the form. The contribution is not a tax and decisions regarding a donation have no effect on the income tax to be paid. Rather, including the line on the individual's income tax form is a way of soliciting funds from a broader constituency than by conventional solicitation methods.

The instructions for the 1990 individual income tax form included another increase in the Retirement Income Exclusion from \$8,000 to \$10,000. Additionally, individuals with Adjusted Gross Income of \$40,000 or more was required to attach a copy of their federal 1040 or 1040A, pages 1 and 2, to their Georgia return. No federal schedules were required.

In 1990, the requirement to adjust taxable income for Teachers was removed. Individuals retiring in 1990 were instructed to subtract the adjustment made for tax years 1987-1989.

For tax year 1991, the main change related to the federal tax breaks granted to military personnel who served in the Persian Gulf combat zone. Georgia observed the same guidelines as the federal requirements.

The individual income tax changes made during 1992 primarily benefit the lower-income individuals or areas within the state. These changes are:

(1) *Low Income Tax Credit.* The credit applies to individuals with income less than \$20,000 per year who are not claimed on another individual's return, who did not receive food stamps for any part of the taxable year and are residents of Georgia, and

(2) *Basic Skills Education Credit for Employers Only.* An employer who provides or sponsors basic skills education can receive a credit of one-third the cost of the education, not to exceed \$150 per full-time equivalent student.

The only legislation effective for tax year 1993 was to conform to the federal Internal Revenue Code. Changes enacted for 1994 were much more extensive.

As Georgia acquired more experience with running a lottery, the deficiencies regarding taxation and withholding of taxes on prize winnings became apparent. Legislation to remedy these deficiencies by imposing a tax and requiring withholding on prizes of $5,000 or more was enacted effective for tax years beginning on or after January 1, 1994.

The exemption per individual increased for tax years beginning on or after January 1, 1994 to $2,000 from $1,500; effective for tax years beginning on or after January 1, 1995, the exemption amount increases to $2,500. Individuals receiving retirement income benefitted from the legislation that raised the exemption amount from $10,000 to $11,000 per individual effective for tax years beginning on or after January 1, 1994. For tax years beginning on or after January 1, 1995, this amount increases to $12,000.

The definition of "periodic payments" was included and the withholding requirements were defined for tax year 1994. The primary purpose of this legislation was to clarify the meaning of payments from annuities, pension, or similar funds and the withholding treatment thereof.

Effective for taxable years beginning on or after January 1, 1994, the Business Expansion Support Act of 1994 provides tax credits to employers for development in the less developed counties and in inner cities of the state. Counties are classified according to their degree of development; different limitations and credits apply based on these classifications. Benefits to employers include tax credits for expansion of employment, for qualified investment property, for child care provided to employees, and for approved retraining programs. The legislature also enacted a bill to ensure that Georgia tax requirements remained in accordance with the federal Internal Revenue Code for 1994.

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